

INTRODUCTION

Directors are placed in a position of trust by the bank's shareholders, and both statutes and common law place responsibility for the affairs of a bank firmly and squarely on the board of directors. The board of directors of a bank should delegate the day-to-day routine of conducting the bank's business to its officers and employees, but the board cannot delegate its responsibility for the consequences of unsound or imprudent policies and practices, whether they involve lending, investing, protecting against internal fraud, or any other banking activity. The board of directors is responsible to the bank's depositors, other creditors, and shareholders for safeguarding their interests through the lawful, informed, efficient, and able administration of the institution. In the exercise of their duties, directors are governed by federal and state banking, securities, and antitrust statutes, as well as by common law, which imposes a liability on directors of all corporations. Directors who fail to discharge their duties completely or who are negligent in protecting the interests of depositors or shareholders may be subject to removal from office, criminal prosecution, civil money penalties imposed by bank regulators, and civil liability. Title IX of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 greatly enhanced the enforcement powers of the federal bank regulatory agencies, including the Federal Reserve Board. Section 5040 of this manual, "Formal Corrective Actions," describes those enforcement powers in greater detail.

DIRECTOR SELECTION

The affairs of each state member bank are overseen by its board of directors. The initial directors are elected by the shareholders at a meeting held before the bank is authorized to commence business. Thereafter, they are elected at meetings held at least annually on a day specified in the bank's bylaws. The directors hold office for a stated tenure, generally ranging from one to three years, or until their successors

are elected and have qualified. No state member bank is to have less than five or more than 25 directors as specified in section 31 of the Banking Act of 1933. Various laws govern the election, number, qualifications, oath, liability, and removal of directors and officers, as well as the disclosure requirements for their outside business interests. Other laws pertain to certain restrictions, prohibitions, and penalties for securities dealers serving as directors, officers, or employees; director interlocks; purchases of assets from, or sales to, directors; commissions and gifts for procuring loans; embezzlement; abstraction; willful misapplication; false entries; political contributions; and other matters. The examiner must be familiar with these laws and the related regulations and interpretations.

DIRECTOR INDEPENDENCE

Directors must exercise their independent judgment when managing the bank's affairs. A responsible board will not merely rubber-stamp management's recommendations, but will review them carefully before deciding whether they are in the bank's best interests. A board that is excessively influenced by management, a single director, or a shareholder, or any combination thereof, may not be fulfilling its responsibilities to depositors, other creditors, and shareholders. Diversification of the board of directors is important and can be accomplished by including directors with no ownership or family-ownership interest in the bank and who are not employed by the bank.

A bank's board of directors may include one or more advisory directors. Advisory directors generally do not vote but may provide additional information or advice to the voting directors. An advisory director who functions in that capacity is generally not subject to the same regulatory requirements as voting members and has less liability for the board's actions. However, if an advisory director exercises a degree of influence or control over the board or the bank that is not commensurate with that status, it is appropriate for examiners to subject that individual to the same standards as voting directors. Such a person might also be subject to the same liability standards as a voting director.

DIRECTORS' RESPONSIBILITIES

Directors play a critical role in overseeing the affairs of the bank. Directors should understand that if they neglect to carry out their fiduciary duties and responsibilities, they may be financially liable if the bank fails or experiences loss. An examiner sometimes has to remind bank directors of the extent of their duties and responsibilities. Unless bank directors realize the importance of their positions and act accordingly, they are failing to discharge their obligations to the shareholders, depositors, other creditors, and the community.

Selection of Competent Executive Officers

One of the board's most important duties is to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly. The board is also responsible for removing officers who do not meet reasonable standards of honesty, competency, executive ability, and efficiency. The responsibility for selecting executive officers also entails retaining them and ensuring that competent successors can be promoted or hired to fill unanticipated voids. The board is responsible for evaluating the performance of the chief executive officer and approving the CEO's compensation. In many banks, the board also approves compensation for other executive officers.

A state member bank that has been chartered or undergone a change of control within the last two years, that is not in compliance with the minimum capital adequacy guidelines or regulations of the Board, or that is in an otherwise troubled condition must provide 30 days' written notice to its regulating Reserve Bank before it can add a director, promote an internal staff member to senior executive officer, or employ a new senior executive officer.

Effective Supervision of Bank Affairs

The type and degree of supervision required of a bank's board of directors to ensure a bank is soundly managed involve reasonable business judgment and competence and sufficient time to become informed about the bank's affairs. Directors ultimately are responsible for the

soundness of the bank. If negligence is involved, a director may be personally liable. The responsibility of directors to supervise the bank's affairs may not be delegated to the active executive officers or anyone else. Directors may delegate to executive officers certain authority, but not the primary responsibility of ensuring that the bank is operated in a sound and legal manner.

Adoption and Adherence to Sound Policies and Objectives

The directors' role is to provide a clear framework of objectives and policies within which the chief executive officer can operate and administer the bank's affairs. This framework is often accomplished through the use of strategic plans and budgets. The strategic plan would discuss long-term, and in some cases, short-term goals and objectives as well as how progress toward their achievement will be measured. The objectives and policies should cover all areas of the bank's operations. The board of directors is responsible for establishing the policies that govern and guide the day-to-day operations of the bank, so they should review and approve them from time to time. These policies are primarily intended to ensure that the risks undertaken by the banks are prudent and are being properly managed. This means that the board of directors must, as a group, have a fundamental understanding of the various types of risks associated with different aspects of the banking business, for example, credit risk, foreign-exchange risk, or interest-rate risk, and define the types of risks the bank will undertake. Some of the more important areas in which policies and objectives must be established include investments, loans, asset and liability management, profit planning and budgeting, capital planning, and personnel. Directors are also responsible for adopting policies and procedures required by law or regulation, such as real estate lending policies, a security program, an inter-bank liabilities policy, and a Bank Secrecy Act program. The examination of these policies is covered in other sections of this manual.

Avoidance of Self-Serving Practices

A bank's directors bear a greater than normal responsibility for upholding safe and sound

practices in dealing with transactions involving other members of the directorate and their related interests. Directors' decisions must preclude the possibility of partiality or favored treatment. Unwarranted loans to a bank's directors or their interests can be a serious safety-and-soundness concern for the bank. Directors who become financially dependent on their bank normally lose their usefulness as directors. Other self-serving practices the examiner should watch for are—

- gratuities paid to directors to obtain their approval of financing arrangements or the use of particular services,
- the use of bank funds by directors, officers, or shareholders to obtain loans or transact other business (Directors should be especially critical of correspondent bank balances when officers, directors, or shareholders are borrowing from the depository bank. The Department of Justice's position is that certain interbank deposits connected with a loan to officers, directors, or shareholders of the depositing bank might constitute a misapplication of funds in violation of 18 USC 656), and
- transactions involving conflicts of interest (When board decisions involve a potential conflict of interest, the director with the potential conflict should fully disclose the nature of the conflict and abstain from voting on the matter. The abstention should be recorded in the minutes. The examiner should also be aware that ethical conflicts of interest can arise when a director or director-related firm performs professional services for the bank. For example, a director who is also the bank's legal counsel may not, in some situations, be able to advise or represent the bank objectively.).

Awareness of the Bank's Financial Condition and Management Policies

Management Information Systems

A management information system (MIS) provides the information, often originated from an institution's mainframe and microcomputers, necessary to manage an organization effectively. MIS should have clearly defined guidelines, policies, practices, standards, and procedures for the organization. These should be incorporated

in the development, maintenance, and use of MIS throughout the institution.

MIS is used by all levels of bank staff to monitor various aspects of bank operations, up to and including its overall risk-management process. Therefore, MIS should be supportive of the institution's longer term strategic goals and objectives. At the other extreme, these everyday financial accounting systems also are used to ensure that basic control is maintained over financial recordkeeping activities. Since numerous decisions are based on MIS reports, appropriate control procedures must be set up to ensure that information is correct and relevant.

Audits

In May 1993, pursuant to requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the FDIC issued rules and guidelines that require all banks with total assets in excess of \$500 million to have annual audits by an independent public accountant. Copies of these audit reports are to be sent to the FDIC and the appropriate Federal Reserve Bank. Furthermore, the Federal Reserve encourages banks with assets of \$500 million or less to provide for annual audits by independent public accountants.

The board or a committee designated by the board should review the audit reports with the bank's management and the independent public accountants. The review should include—

- the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates;
- the adequacy of internal controls, and actions necessary to ensure the resolution of any problems or deficiencies; and
- the institution's compliance with applicable laws and regulations.

Many states have laws requiring directors' examinations of the bank. When the directors lack adequate knowledge of examination techniques and procedures, they are encouraged to employ a qualified accountant or other specialist to conduct all or part of this examination. The examining committee or the entire board should play an active role. Directors should obtain a clear understanding of the scope of the procedures to be employed, and the final report of the

directors' examination should be reviewed by the board of directors.

Further guidance on the use of audit reports and the reliance placed upon the work of external and internal auditors in the examination process can be found in the "Internal and External Audit Section" of this manual.

Maintenance of Reasonable Capitalization

A board of directors has the responsibility for maintaining its bank on a sufficiently capitalized basis. Capital planning and capital adequacy are discussed in the manual section "Assessment of Capital Adequacy," and the examiner should be familiar with this information.

Compliance with Banking Laws and Regulations

Directors must carefully observe that banking laws are not violated; they may be personally liable for losses arising out of illegal actions. In addition, civil money penalties can be assessed for unsafe and unsound actions that do not necessarily involve a violation of a banking law.

Guarantee of a Beneficial Influence on the Community's Economy

One reason for approving a newly chartered bank for Federal Reserve membership is to meet a specific community need. Directors, therefore, have a continuing responsibility to provide those banking services which meet the legitimate credit and other needs of the community being served. Directors should be certain that the bank attempts to satisfy all legitimate credit needs of the community.

BOARD MEETINGS

The board should conduct its business in meetings held as required by the bank's bylaws or state law. Regular meetings of the board should review statements showing the bank's financial condition and earnings; the investment portfolio; and loan activity, including past-due and

nonaccrual loans, charged-off or recovered loans, large new loans, and loans to insiders. Directors should also review and approve all policies annually, and review and approve all insurance policies as they are obtained or renewed. They should also review audit and examination reports and initiate action to correct any deficiencies noted, review correspondence with regulatory agencies, review pending litigation, and keep informed of any major prospective undertakings, such as mergers, acquisitions, or new branches or construction.

Minutes of Board Meetings

The board should ensure that an accurate, adequate record of its actions is maintained. Such a record is usually kept in the form of minutes of the board meetings. The minutes should document the board's review of all regular items mentioned above as well as the review and discussion of all significant items that are not part of the regular meeting. Additionally, at a minimum, the minutes should record the attendance or absence of each director at each meeting, detail the establishment and composition of any committees, and note the abstention of any director from any vote. Examiners should review the minutes of board meetings, as well as a sample package prepared for a board meeting, to determine that directors are receiving adequate information to make informed, sound decisions. Meetings conducted by telephone, if allowable under state law, should be documented as thoroughly as regular meetings.

BOARD COMMITTEES

Many boards elect to delegate some of their workload to committees. The extent and nature of the bank's activities and the relative expertise of each board member play key roles in the board's determination of which committees to establish, who sits on them, and how much authority they have. Thus, there is no ideal committee structure. However, committees frequently found in state member banks include the following:

- *Executive Committee*—may be empowered to act when the full board is unable to meet, for

example, between regular meetings. An executive committee is usually found in large institutions, where it relieves the full board of the burden of reviewing the details of financial statements and operational activities.

- *Audit Committee*—typically monitors compliance with bank policies and procedures, and reviews internal and external audit reports and bank examination reports. Because it is responsible for ensuring compliance, accuracy, and integrity throughout the organization, the audit committee should consist only of outside directors. The audit committee may supervise the bank's internal auditor and his or her staff directly by hiring personnel, evaluating their performance, and setting their compensation.
- *Loan Committee*—may be established to monitor underwriting standards and loan quality, and to ensure that lending policies and procedures are adequate. In most banks with loan committees, all new loans are reviewed by the loan committee either before or after funding, with the threshold for prior approval being the amount of either the loan or the aggregate debt to the borrower. The loan committee may also be responsible for the loan review function and for maintaining an adequate reserve for loan losses.
- *Investment or Asset-Liability Management Committee*—monitors the bank's investment policies, procedures, and holdings portfolio to ensure that goals for diversification, credit quality, profitability, liquidity, community investment, pledging requirements, and regulatory compliance are met. In some banks whose complexity warrants it, asset-liability management committees have been established to replace or supplement investment committees. An asset-liability management committee monitors the bank's balance sheet and external forces, notably interest rates, to help coordinate asset acquisition and funding sources.
- *Other Committees*—depending on the nature and complexity of the bank's business, the board may establish other committees to monitor such areas as trust, branching, new facilities construction, personnel/human resources, electronic data processing, and consumer compliance.

Minutes of all major actions taken by committees that play a significant role in managing the bank should be kept and meet the same

minimum standards used for minutes of meetings of the full board.

COMPLIANCE WITH FORMAL AND INFORMAL ADMINISTRATIVE ACTIONS

Bank directors must ensure that management corrects deficiencies found in the bank. Instructions to do so may come from the Federal Reserve as a formal or informal administrative action, depending on the severity of the problem.

Formal actions, which include cease-and-desist orders and written agreements, are normally exercised when banks have serious problems. For less serious problems, the Federal Reserve issues informal actions such as a "memorandum of understanding." Informal actions are an agreement between the Reserve Bank and the bank that sets forth the required corrective actions. The Reserve Banks are generally responsible for monitoring compliance with both types of administrative actions. To assist in that process, the Reserve Bank normally receives and evaluates periodic progress reports from the bank. In addition, information is provided by the examiner who checks the bank's compliance with the action. The Reserve Banks may initiate additional supervisory action against the bank or individuals associated with it when compliance is insufficient. Or, if the bank's compliance with the action is satisfactory, the Reserve Banks may recommend modifying or terminating the enforcement action.

Examiners should briefly discuss compliance with any enforcement actions on the Examination Conclusions and Comments page and direct the board of directors' attention to the Compliance with Enforcement Actions page of the examination report. The type and date of the action or resolutions and parties to the action should be listed. In addition, the examiner should generally list each provision requiring action by the bank and provide a comment addressing compliance with that provision. The examiner should comment on how the bank accomplished compliance or the problems that have prevented compliance. While certain information might be better discussed in the confidential section of the report, it is appropriate to make all salient negative comments on the Compliance with Enforcement Actions page to ensure that the

directors are made aware of any deficiencies and/or exceptions that may exist.

The Reserve Bank may recommend termination or modification of a formal administrative action whenever it determines that such restraints have satisfactorily served their purpose and should be removed or modified. In these cases, the Reserve Bank will send a memorandum with the appropriate explanation to the Board's Division of Banking Supervision and Regulation (BS&R) for review and evaluation. BS&R and the Board's Legal Division, when appropriate, will prepare the documents necessary to terminate or modify the existing administrative action.

DEPOSITORY INSTITUTION MANAGEMENT INTERLOCKS ACT

Under the Depository Institution Management Interlocks Act (Interlocks Act) as implemented by Regulation L, interlocking relationships of management officials of various nonaffiliated depository institutions are prohibited, depending on the asset size and geographical proximity of the organizations. The enforcement of the interlock provisions of the Interlocks Act encompasses full cease-and-desist powers.

The intent of the Interlocks Act is to foster competition among various depository institutions by prohibiting interlocking relationships of management officials. The prohibitions, how-

ever, do not generally apply to the following organizations and their subsidiaries:

- a depository institution that does not do business in the United States except as an incident to its activities outside the United States;
- an Edge or agreement corporation;
- a depository organization in formal liquidation or a similar type situation;
- a credit union being served by a management official of another credit union;
- a state-chartered savings and loan guaranty corporation; or
- a Federal Home Loan Bank or other bank organized solely for the purpose of serving depository institutions or solely for the purpose of providing securities clearing services and related services related to other depository institutions.

In addition, five other exceptions are permitted, with Federal Reserve Board approval, based on the public benefit that is derived from the interlocking relationship and on the competitive nature of the institutions involved. These exceptions are for—

- institutions located in low-income areas or controlled or managed by members of a minority group or by women,
- newly chartered institutions,
- institutions facing conditions endangering safety and soundness,
- institutions sponsoring a credit union, and
- institutions affected by loss of management officials due to changes in circumstances.

Duties and Responsibilities of Directors

Examination Objectives

Effective date November 1995

Section 5000.2

1. To determine whether the board of directors fully understands its duties and responsibilities.
2. To determine if the board of directors is discharging its responsibilities in an appropriate manner.
3. To determine whether the board of directors has developed adequate objectives and policies.
4. To determine the existence of any conflicts of interest or self-dealing.
5. To determine compliance with laws and regulations.

Duties and Responsibilities of Directors

Examination Procedures

Effective date March 1984

Section 5000.3

1. Update the following and review for possible violations of law:
 - a. A list of directors to include:
 - Home address (if the director was appointed or elected since the previous examination, state the number of years residing at present address).
 - Date of birth.
 - Years as a director of the bank.
 - Approximate net worth.
 - Occupation.
 - Citizenship.
 - Common stock ownership (beneficial, direct and indirect).
 - Bonus, fees, etc.
 - b. A list of embezzlements, defalcations, misappropriations, mysterious disappearances, or thefts which have occurred since the last examination. That list should be signed by the chief executive officer or the auditor.
 - c. A list of management officials (as defined in the Depository Institution Act) of the bank, its holding company and holding company affiliates who are management officials of other depository institutions.
 - d. A list of the indebtedness of directors, executives officers, and principal shareholders to the bank examined and any other bank along with a statement of the terms and conditions of each extension of credit.
2. Obtain or update a listing of all areas of the bank's operations which are administered under the provisions of written objectives and policies which have been developed by or with the approval of the board. Inform the examiners doing those various departments that a policy has been developed or an update has occurred.
3. Analyze the listing obtained in step 2 and note any area of banking activity for which policies should be developed.
4. Determine that the board has accepted its responsibility to effectively supervise the affairs of the bank and to be informed of the bank's condition by:
 - a. Obtaining a complete set of the latest reports furnished to directors at the last meeting and listing the areas of operation covered by the reports.
 - b. Distributing the copies of the reports to the examiners in other areas and requesting them to determine if reports furnished to the board are prepared accurately, contain sufficient detail to allow the directors to make an intelligent decision and are submitted on a timely basis.
 - c. Preparing a list of areas not reporting or of reports the board does not receive which are considered necessary to maintain adequate supervision. As guidelines, consider the following reports:
 - A monthly statement of condition or balance sheet and a monthly statement of income. Those statements should be in reasonable detail, and compared to the prior month, the same month of a prior year and to the budget. The directors should receive explanations for all large variances.
 - Monthly statements of changes in all capital and reserve accounts. Such statements should explain any changes.
 - Investment reports which group the securities by classifications, reflect the book value, market value, yield, and a summary of purchases and sales.
 - Loan reports which list significant past due loans, trends in delinquencies, rate reductions, non-income producing loans, and large new loans granted since the last report.
 - Audit and examination reports. Deficiencies in those reports should produce a prompt and efficient response from the board. The reports reviewed and actions taken should be reflected in minutes of the board of director's meetings.
 - A full report of all new executive officer borrowing at any bank.
 - A monthly listing of type and amount of borrowing by the bank.
 - An annual presentation of bank insurance coverage.
 - All correspondence addressed to the board of directors from the Federal Reserve and any other source.
 - A monthly analysis of the bank's liquidity position.

- An annual projection of the bank's capital needs.
 - A listing of any new litigation and a status report on existing litigation and potential exposure.
 - A thorough report on any major bank endeavor upon which each bank director is expected to make a decision. That would include branch applications and major building plans.
- d. Determining the mechanism used to assign responsibility for correcting deficiencies noted in regulatory reports, internal audit reports, external audit reports or any other reports to the board, and the board's system of determining compliance with such recommendations.
 - e. Determining how directors perform a director's examination, the frequency of such examinations, and what part the directors take in the process.
 - f. Reviewing the bank's method of ensuring continued or resumed operations in the event of a disaster. Complete the Emergency Preparedness Measures Questionnaire for inclusion in the workpapers.
 - g. Reviewing correspondence between the Federal Reserve and the bank to determine that such had been properly reported.
5. Determine evidence of conflicts of interest and self-dealing by:
 - a. Obtaining and summarizing information on the business interests of directors, executive officers, and principal shareholders.
 - b. Comparing the information to develop a list of directors who have business interests in common.
 - c. Analyzing the interests of directors to determine if the board is comprised of a variety of individuals.
 - d. Obtaining from the examiner assigned "Assessment of Capital Adequacy" a list of shareholders who own or control, either directly or indirectly, 5 percent or more of any class of voting security.
 - e. Distributing a list of the insiders (directors, officers and 10 percent shareholders) and their interests to the appropriate examining personnel to ascertain the extent of loans to or transactions with insiders and their interests. Those examiners should be alert for any relationship with insiders' interests which are not included on the list.
 - f. Requesting appropriate examiners to determine if any transactions with insiders are on terms more favorable than those offered to other customers. If so, determine whether the board has approved such transactions.
 - g. Determining that directors have reviewed their correspondent bank accounts in relation to possible conflicts of interest arising from directors, officers or shareholders borrowing from depository banks.
 - h. Correlating all information on insider transactions and preparing appropriate report comments.
6. Obtain the minutes of the meetings of the board of directors, the charter, the by-laws, and the minutes of shareholders' meetings and:
 - a. Review and summarize the by-laws and charter of the organization including any specific provisions with respect to the requirements of directors. The resulting material should become a permanent part of the workpapers and should be updated at subsequent examinations.
 - b. Read and summarize the minutes of all meetings of the board since the last examination making certain to:
 - List any actions taken in contravention of the by-laws.
 - Record major actions taken by the board which are not a part of a normal monthly meeting.
 - Record any resolution or discussion covering development of or entrance into a new area such as geographic area, customer service, asset category or liability category.
 - Record the creation of any special committee and the area with which it is designed to deal.
 - Determine that actions taken by standing committees are reviewed and ratified by the full board.
 - If the minutes specify any transactions with directors or their interests, determine that the abstention of any interested director from voting on the matters is noted.
 - If the minutes do not mention any director related transactions which have been uncovered during the examina-

- tion, make an inquiry to determine that the interested director did refrain from voting.
- c. Read and summarize the minutes of the board's annual organization meeting and:
 - List standing committees and their members.
 - Have examiners who are examining areas which have standing committee supervision read and summarize the minutes of those committees.
 - Prepare a list of major areas of operation which are not monitored by specific committees.
 - d. Read and summarize the minutes of any stockholders' meetings. The summary should include a list of directors elected at the annual meeting, the number of shares present and voted, individuals acting as proxies, and specific action approved by shareholders.
 - e. Ascertain during the review of shareholders' meeting minutes that (1) shareholders' approval has been received for; (2) the bank's charter amended, if necessary; for; and (3) compliance with appropriate state and/or federal statutes has been met for:
 - Any establishment of or change of a branch location outside the city limits since the preceding examination. (See letter S-1642 which clarifies section 208.9(b)(7) of Regulation H regarding moves of very short distances.)
 - Any issuance of preferred stock.
 - Any increase in capital stock, either through sale or through a stock dividend.
 - Any reduction in capital stock, and ascertain whether the resultant capital is not below that required by the capital adequacy guidelines.
 - Any stock split.
 - Any bank pension plan established since the preceding examination.
 - Any bank involvement in a conversion, merger, and/or consolidation.
 - All other matters subject to vote.
 - f. Determine the date of the annual shareholders' meeting, and that it was in compliance with the by-laws.
 - g. Review the charter and/or by-laws with reference to quorum requirements for shareholder meetings. Ascertain that, at any meeting, the quorum requirements were satisfied either according to recorded requirements or more than one-half of the eligible shareholders were represented.
 - h. Review any stock option or stock purchase plan adopted since the preceding examination, and review such action for compliance with the various conditions involving charter and shareholder approval.
 - i. Determine if any candidate was nominated for director, other than the slate nominated by bank management, and review for compliance with the appropriate state statute.
7. Determine that the directors have accepted their responsibility for selecting competent officers by:
 - a. Determining that the board or a committee thereof reviews, at least annually, the chief executive officer's performance in attaining or progressing toward attaining specific objectives or goals set by the board.
 - b. Determining if a policy statement on personnel exists and ascertaining what provisions the board has made for successor management.
 - c. Determining if any management contracts exist and if one does, obtain a copy, summarize the pertinent points, and determine reasonableness of terms.
 - d. Determining by inquiry how the remuneration of executive officers is set and who makes decisions concerning executive salaries.
 - e. Listing any titled individual who, by action of the board, is specifically excluded from being an executive officer.
 8. Determine compliance with laws and regulations by:
 - a. Reviewing workpapers of other examination areas or discussing with other examiners, to determine any violations of laws or regulations concerning directors that were disclosed in these examination areas.
 - b. Reviewing the nature and extent of violations discovered at prior examinations to determine if similar violations have occurred at this examination.
 - c. Correlating information obtained from the minutes of board meetings to the

- reports of officer borrowings which have been prepared at and forwarded from other banks to determine that all such borrowings have been reported to the board.
9. Determine compliance with the Foreign Corrupt Practices Act (15 USC 78dd-1 and 2) by:
- Reviewing the bank's policy prohibiting improper or illegal payments, bribes, kickbacks, etc., to any foreign government official or other person or organization covered by the law.
 - Determining how that policy has been communicated to officers, employees or agents of the bank.
 - Reviewing any investigation or study done by, or on behalf of, the board of directors of the bank's policies and operations concerning the advance of funds in possible violation of the act.
 - Reviewing the work done by the examiner assigned "Internal Control" to determine whether internal/external auditors have established routines to discover improper/illegal payments.
 - Analyzing the general level of internal control to determine whether there is sufficient protection against improper/illegal payments being inaccurately recorded on the bank's books.
 - Requesting examiners working in other areas of the bank to be alert for any transactions that might violate the provisions of the act.
 - Compiling any information discovered throughout the examination on possible violations.
 - Performing procedures on suspected criminal violations contained in the Examination Procedures of the manual section on Overall Conclusions Regarding Condition of the Bank.
10. Answer the following questions. This questionnaire is intended to provide a means for quick review in determining that all laws and regulations pertaining to directors have been complied with. Questions should be answered "no" and sub-questions should be answered "yes." Any deviation from this pattern indicates a violation or potential violation. Such situations which are not judged to be violations require comments stating the basis for that judgment.
- Is the number of directors less than 5 or greater than 25 (section 31, Banking Act of June 16, 1933)?
 - Have any directors failed to qualify by reason of insufficient stock ownership (12 USC 72)?
 - Are any directors noncitizens of the United States (12 USC 72)?
 - If so, has citizenship requirement been waived?
 - Do more than one-third of the directors fail to reside in the state, territory or district in which the bank is located, or within 100 miles of the bank's head office (12 USC 72)?
 - Did more than one-third of the directors fail to reside in the state, territory or district in which the bank is located, or within 100 miles of the bank's head office for one year prior to election (12 USC 72)?
 - Are any directors engaged in the underwriting, sale or distribution of stocks, bonds or similar securities (Regulation R (12 CFR 218))?
 - If so, has Federal Reserve Board approval been obtained?
 - Are any transactions with directors or their related interests on more favorable terms than those offered to other customers (Regulation O (12 CFR 215))?
 - Do the deposit accounts of directors receive greater interest than those of other customers (section 22(e), Federal Reserve Act (12 USC 376))?
 - Have any provisions of a cease and desist agreement or order been violated (Rules of Practice for Hearings (12 CFR 263))?
 - Has any director, officer or employee been convicted of a crime involving a breach of trust or act of dishonesty (section 8(g) of the Federal Deposit Insurance Act (12 USC 1829))?
 - If so, has the FDIC approved his or her membership on the board or employment?
 - Have any tie-ins of services been authorized by the board (Regulation Y (12 CFR 225.4(d)))?
 - Were any loans to bank examiners disclosed (Criminal Code—18 USC 212 and 213)?
 - Has the bank made any political contributions (Federal Election Campaign Act (12 USC 441b))?

- n. Have any employees been found to have misappropriated funds, made false entries, or otherwise defrauded the bank (18 USC 656)?
 - o. Has an officer of the bank failed to make appropriate written reports when an embezzlement, misapplication, or similar transaction occurred (SR-579)?
 - p. Have any extortionate extensions of credit been discovered (18 USC 892 through 894)?
 - q. Have any checks been certified against uncollected funds (18 USC 1004)?
 - r. Have unauthorized obligations of the bank been issued (18 USC 1005 and 1006)?
 - s. Has there been a change in control (Regulation Y (12 CFR 225.41–225.43))?
 - If so, was the Federal Reserve notified and was the application not disapproved?
 - t. Have any purchase money loans been made which are secured by 25 percent or more of the stock of another secured banks (Regulation Y (12 CFR 225.41))?
 - If so, have the appropriate authorities been notified?
 - u. Has the bank failed to maintain records of directors, executive officers, and principal shareholders and the related interest of those persons (Regulation O (12 CFR 215.7))?
 - v. Are management officials of the bank or its holding company or holding company affiliates, management officials of an unaffiliated depository institution or depository holding company (Regulation L (12 CFR 212))? If so:
 - Was such relationship established prior to November 10, 1978 and previously permitted by section 8, Clayton Anti-Trust Act (15 USC 19)?
 - Was prior approval of the Federal Reserve obtained for a relationship that was developed since November 10, 1978?
 - Does the interlocking relationship meet the criteria of one of the exceptions permitted by Regulation L (12 CFR 212)?
 - Is the management relationship with an institution whose:
 - Principal offices or branches, excluding electronic terminals, are located in a different SMSA from the bank's or its holding company's offices or branches (does not apply if either institution has assets of less than \$20MM)?
 - Principal offices or branches, excluding electronic terminals, are located in another city, town or village not contiguous or adjacent and 10 miles or more apart?
 - If the bank or its holding company has assets exceeding \$1 billion, does the interlocking management relationship exist with a nonaffiliated depository institution holding company with assets of \$500MM or less?
 - w. Have any loans to officers been uncovered which were not reported to the board (Regulation O (12 CFR 215) and 12 USC 503)?
 - x. Has a majority of the board failed to preapprove extensions of credit to any of the bank's executive officers, directors, major shareholders and their interests when the total loans to the individual exceeds the amount prescribed in Regulation O?
 - y. Has the bank notified executive officers and principal shareholders of their reporting requirements (Regulation O (12 CFR 215))?
- 11. Determine compliance with administrative actions by:
 - a. Reviewing provisions of the document.
 - b. Reviewing bank records and performing necessary procedures to isolate noncompliance.
 - 12. Evaluate bank's compliance with formal or informal administrative actions and prepare comments for page one of the examination report (SR-82-8).
 - 13. Determine compliance with conditions imposed in the approvals of corporate filings for:
 - a. Branches and relocation applications, including:
 - Capital plans or capital injections.
 - Fixed asset limitations.
 - CRA plans.
 - b. Subordinated debt, operating subsidiaries, interim bank applications, including:

- Capital plans.
 - Prior review and appropriate clearance of disclosures.
14. Based on the information obtained by performing the foregoing procedures, or any other procedures deemed appropriate, evaluate the adequacy and effectiveness of the board of directors. The evaluation should include, but is not limited to:
 - a. The frequency and effectiveness of meetings.
 - b. The effectiveness of board committees.
 - c. The director's role in establishing policy.
 - d. The adequacy of the policies and major inconsistencies therein.
 - e. The quality of reports for directors noting any deficiencies in information flows from operating management.
 - f. Violations of laws and regulations.
 - g. Whether any one person or group appears to control or dominate the board; if so, comment on any adverse effects on operating policies, procedures, or overall financial condition of the bank.
 - h. Responsiveness to recommendations from the auditors and supervisory authorities.
 15. Update the workpapers with any information that will facilitate future examinations.

The purpose of this section is to guide the examiner in evaluating bank management. Although the directorate is an integral part of the overall management of a bank, the management appraisal examination program is concerned primarily with the active officers. A review of the quality of director guidance and supervision is covered in "Duties and Responsibilities of Directors."

It is the responsibility of directors to employ a competent chief executive officer. Thereafter, senior management normally assumes the responsibility to employ, maintain and educate a qualified staff. Since a direct relationship exists between the overall condition of a bank and the quality of management, the first priority in evaluating the condition of the bank is to make an accurate appraisal of the competency of the management team.

Management is responsible, not only for the operations of the bank and the quality of its assets on a day-to-day basis, but also for planning for the future. Senior management should be evaluated on its plans for maintaining or improving the condition of the bank in the future as well as on the bank's present condition. The depth of planning and a general forward looking attitude of executive officers should be considered when projecting future management impact. This should include an evaluation of management's efforts to provide for succession of senior bank officials.

The projection of future management impact involves an appraisal of the quality and quantity of senior and middle management. This assessment of course must be relative to the size and community circumstances of the bank. Examiners must not restrict their appraisals to the past and present. The past and present certainly are significant, requiring an in-depth analysis of financial condition, earnings and capital adequacy, both on an absolute basis and as a trend, but, the determination of what the management will do for the bank in the future is most significant. The System's goal is to prevent problems from developing rather than waiting for future examinations to identify deteriorating conditions.

Bank management receives strong pressure from customers, stockholders and competitors. Customers demand more for their money, in the form of both interest and services, and stockholders demand higher returns on their invest-

ments, both in dividends and increased market value of their stock. No bank is completely free from the pressure of competition and, for most institutions, this is one of the strongest forces felt. In the midst of those pressures, the clear mandate to bank management is to "perform." Performance is measured in terms of long-run profitability, liquidity and solvency. It is almost impossible for a bank to achieve those long-range goals unless careful planning and coordination bring efficiency to its activities. Management must recognize the bank's position in the market and make plans which will achieve the objectives set for the institution by the directors. It must be constantly alert to the need for continually upgrading and expanding services and facilities to support and encourage the bank's growth.

Both the directors and senior management have important roles in a bank's program of internal control and internal audit. Although directors have overall audit responsibility and should require that the auditor report directly to them, senior management normally is charged with the duty of maintaining a strong system of internal control.

The entire examination procedure, as outlined throughout this manual, is designed to provide a clear picture of both the present and anticipated future condition of the bank under examination. As a result, the reports and workpapers generated by the examination process will serve as a major tool for examiners in their evaluation of management. Examination procedures for various balance sheet accounts and departmental areas are designed to effect a comprehensive evaluation of internal control and internal and/or external audit, and will provide the examiner with insight into the degree of compliance with the bank's own written policies in such areas. Similarly, the examination procedures in "Loan Portfolio Management," "Investment Securities," "Funds Management," "Assessment of Capital Adequacy," and "Analytical Review and Income and Expense" are designed to lead to a detailed analysis of written objectives, policies and procedures in those management areas.

The examiner must take a practical approach to evaluating these features depending on the bank's characteristics. The examiner can have greater confidence in the continuity of top and middle management when it is known that the

bank has an inflow of new personnel at various levels and that training procedures and advancement policies will keep the organization viable and dynamic.

The examiner must be concerned with salary levels within the bank and must review information collected during the examination about the bank's employee benefits program. Salaries paid and benefits provided should be compared with those offered by an appropriate peer group, and inquiry should be made to determine the relationship between the bank's payroll structure and that offered by competitors for the same caliber personnel.

The examiner must judge the appropriateness of asset distribution in view of the bank's sources of funds. The examiner must evaluate the adequacy of the bank's capital position and expectations in view of asset quality and plans for growth and expansion. The overall management evaluation should be made by the examiner-in-charge, because he or she is in the best position to identify weaknesses and inconsistencies in policies. Although examiners-in-charge will rely heavily upon the information received from assisting examining personnel in various areas under review, it is their task to assemble all of such information into a composite picture of the quality of management.

Senior management is responsible for the quality of all bank personnel and for planning its own replacement. A bank's recruiting, training, and personnel development activities are vital to the development and continuity of a quality

staff. The examiner must evaluate those areas to determine the quality of overall management. Some features of good personnel management are:

- An organizational structure.
- Detailed position descriptions.
- Carefully planned recruiting.
- Appropriate training.
- Performance review.
- Salary administration.
- Provision for communication.

The examiner should identify and interpret trends that can reveal flaws in policy either as written or as practiced. The examiner should question the quality of management in any area in which he or she finds serious shortcomings or makes significant criticisms.

The examiner should be alert for situations in which top management dominates the board or where top management acts solely at the direction of either the board or a dominant influence on the board. Although it is extremely important for the directors to assume their appropriate role in setting objectives and formulating policy consistent with their responsibilities to the depositors, shareholders and regulators, dialogue with top management must occur. In banks where both directors and senior management recognize and assume their appropriate duties and responsibilities, areas for conflict are greatly reduced.

Management Assessment

Examination Objectives

Effective date March 1984

Section 5010.2

1. To determine the consistency of written objectives, policies, and procedures in the various asset, liability, and operational areas.
2. To determine that policies are being adhered to throughout the system.
3. To determine that management plans adequately for future conditions and developments.
4. To evaluate the adequacy of the bank's personnel practices as they relate to management continuity.
5. To evaluate management experience and depth.
6. To determine that management has established systems which facilitate efficient operation and communication.
7. To evaluate the propriety and soundness of management decisions.
8. To project the impact of management on the future condition of the bank.

Management Assessment

Examination Procedures

Effective date March 1984

Section 5010.3

In the following procedural steps examiners should attempt to utilize already developed material from internal or external audit sources. Also, the examining resources and circumstances of the bank must be weighed in perspective to set the depth of scope for this area.

1. Obtain the following, if available:
 - a. Organization chart.
 - b. Management plan.
 - c. Administrative and personal manuals.
 - d. Marketing plan.
 - e. Resumes for all executive officers and department or division heads which have not been obtained in previous examinations.
 - f. A list of the salary of and other compensation paid to each executive officer.
 - g. A list of the salary ranges for other officers of the bank broken down by position.
 - h. A description of other employee benefits.
2. Become familiar with the quality of key personnel by:
 - a. Updating management briefs for all executive officers and department or division heads.
 - b. Distributing the updated management briefs to appropriate examining personnel and requesting that they be returned upon completion.
3. Review administrative manuals and:
 - a. Extract any policy statements contained therein.
 - b. Extract any general information considered relevant in appraising management.
 - c. Analyze the manual(s), in general, as useful management tools.
4. Review management plan and extract information concerning:
 - a. Areas of bank where increased or decreased officer staffing is planned.
 - b. Number of officers to be added or removed.
 - c. Qualification requirements for planned additional officers.
5. Establish the hierarchy of the organization by determining the functional responsibility levels of various officers and whether lines of authority are drawn in accordance with the organization chart.
6. Review the bank's marketing plan for specific programs being planned and general applicability to the institution.
7. Review the bank's schedule of salaries and make comparisons with similar information from an appropriate peer group. If deemed appropriate, compare salaries paid and benefits received in the bank to those of other institutions with which it competes directly. Determine whether the bank is paying salaries or bonuses to inactive officers or directors and, if so, determine that such payments have been disclosed to shareholders.
8. Determine whether any executive incentive compensation plans (performance bonuses) have been established and, if so;
 - a. Review specific provisions of the plans and determine the beneficiaries.
 - b. Review controls established to prevent the beneficiary(s) of the plan from understating noncash expenses (accrual expense accounts, provision for possible loan losses, etc.) or overstating noncash income (accrual income accounts).
9. Review the bank's activities with regard to developing personnel for senior management succession. At a minimum, this review should include:
 - a. An assessment of the quality of lower levels of management and the potential for advancement.
 - b. An assessment of the bank's officer hiring policies to determine that it is appropriate to meet the bank's current and future needs.
10. Obtain and analyze daily or other periodic reports submitted to executive management with the view of determining the usefulness of the reports in monitoring the condition and operation of the bank.
11. As the evaluation of the various areas of examination interest are being completed, discuss with assisting personnel:
 - a. Any of their observations indicative of the general morale level.
 - b. The technical proficiency of officers in their area.
 - c. The level of direct impact that officers have on the condition of their areas.
12. Review the section on "Analytical Review

- and Income and Expense” and extract any information related to financial planning that is considered relevant to evaluating management. Also consider the quality, depth and applicability of financial planning.
13. In conjunction with reviewing the work papers and comments generated during the examination:
 - a. Familiarize yourself with the bank’s written objectives and policies.
 - b. Analyze those policies and determine any inconsistencies in management areas.
 - c. Review any internal control and policy exceptions and any other criticisms made in connection with the examination of all areas of the bank.
 - d. Determine the extent to which improper implementation is negating the effect of written policies and procedures.
 - e. Review the appropriateness of asset distribution in view of the bank’s sources of funds.
 - f. Review the evaluation of the bank’s capital position and expectations in view of asset quality and plans for growth and expansion.
 14. In cases where previously obtained information is incomplete or where no records could be reviewed, interview appropriate management in order to judge quality and depth. The interview should be conducted in such a manner as to generate necessary information for determining:
 - a. Sources of information used to keep current.
 - b. Strengths and weaknesses of lower level personnel.
 - c. Succession of management and replacement of key personnel.
 - d. General management plan.
 - e. Methods of control utilized.
 - f. Workload factors and efficiency of personnel.
 - g. Frequency of staff meetings and how the communications system works.
 - h. Management projections for the institution over the next year.
 - i. Any major new proposal being considered or changes in asset mix or services.
 - j. The nature and degree of working relationship with directors.
 - k. The existence of any time-consuming outside activities of executive management.
 15. By reviewing the results of the preceding steps and performing any other procedures deemed appropriate, answer the following questions (normally these questions will serve as a summary of information obtained, thus compiling factual data to support your objective comments on management):
 - a. Have overall management objectives been set?
 - b. Does the bank forecast manpower requirements?
 - c. Are qualified people advanced from within?
 - d. Are supervisory personnel involved in the selection of new employees and given the right of acceptance or rejection?
 - e. Is management training given to those persons likely to assume higher level positions?
 - f. Are salaries competitive?
 - g. Are employee benefit programs competitive?
 16. Prepare comments on the quality of management supervision. The comments should, at a minimum, discuss the following:
 - a. General and technical ability.
 - b. Effectiveness.
 - c. Experience.
 - d. Any inconsistencies in written objectives, policies and procedures.
 - e. Any serious or widespread lack of proper implementation of written procedures.
 - f. An evaluation of the bank’s salary structure.
 - g. The promptness with which management addresses problems.
 - h. The extent to which executive management delegates and demands accountability.
 - i. Any evidence that executive management is more concerned with the operation of a functional area than with overall supervision of the bank.
 - j. The potential for upward movement of existing management personnel.
 - k. Management’s commitment to effecting corrective action in problem areas.
 - l. Unsafe or unsound management.
 - m. Any situation which might require close monitoring or removal of management.
 17. For banks that are subsidiaries of bank holding companies (BHCs), review the relative degree of centralized control by parent or the lead bank, and evaluate:

- a. The general level of management's dependence on central BHC staff.
- b. Independence on final credit decisions.
- c. Independence on investment decisions.
- d. Independence on operational practices or service fee arrangements.

While examiners may expect that economies of scale or optimization of tax, investment, or credit considerations on a consolidated basis may be beneficial to the entire

organization, examiners must be alert to the danger of such considerations becoming overly burdensome or unfair to the subsidiary bank being examined. (Reference Federal Reserve Policy Statement on Inter-corporate Income Tax Accounting Transactions of Bank Holding Companies and State Member Banks.)

18. Update the workpapers with any information that will facilitate future examinations.

Management Assessment

Internal Control Questionnaire

Effective date March 1984

Section 5010.4

1. Does the bank have an organizational chart?
2. If not, have lines of authority and reporting responsibility been formally established?
3. Does the bank have a full-time personnel manager?
4. Does the bank utilize written personnel manuals?
5. Does the bank utilize a system of written job descriptions, including descriptions for supervisory personnel?
6. Does the bank actively recruit personnel?
7. Does the bank perform background investigations of new employees?
8. Does the bank have a formal training program?
9. Does the bank utilize other than on-the-job training?
10. Does the bank utilize a graded salary scale?
11. Does the bank consider competition in preparing a salary range? If so, in what manner?
12. Does the top management at least annually review lower management?
13. Does the bank prepare or utilize a long-range forecast of economic conditions germane to its trade area?
14. Does top management consult with directors for their opinion of future condition?
15. Does the bank either employ an economist or utilize the services of an outside economic advisor?
16. Does senior management propose to the directors areas for policy decision?
17. Does the bank have a management succession plan?
18. Does the bank employ a marketing manager and/or outside marketing consultant?
19. Does senior management receive:
 - a. A brief statement of condition daily?
 - b. A daily liquidity report?
 - c. A listing of assets subject to quality limitations at least monthly?
 - d. An earnings statement on a comparative basis at least monthly?
20. Does the bank's auditing function audit the officer's adherence to general policy?
21. Are staff meetings held on a regular basis?
22. Are minutes kept for staff meetings?
23. Does the bank use a system of progress reports on specific projects?
24. Does the bank have a tax department or a tax consultant?

Overall Conclusions Regarding Condition of the Bank

Section 5020.1

Effective date May 1988

INTRODUCTION

Throughout this manual, the examiner is encouraged to use objective criteria in evaluating various areas of the bank. However, there will always be a need for subjective judgment in an examination. Formulating an overall conclusion regarding the present and future condition of the bank requires the use of both objective criteria and subjective judgment. As experience is essential in evaluating information in areas requiring subjective judgment, the procedures in this section should be performed by the examiner-in-charge. In performing those procedures, the examiner's primary concerns are—

- to make the ultimate determination as to—
 - the solvency of the bank and its ability to meet maturing and unusual demands in the ordinary course of business,
 - adherence to safe and sound banking practice,
 - adherence to the law, and
 - the continued viability of the institution; and
- to communicate the results of the examination to the Federal Reserve System and the directors of the bank.

The evaluation of the overall condition of the bank is based on conditions found throughout the institution. Considerations include internal control and policy exceptions, violations of law and regulations, quality of management, adequacy of earnings and capital, quantities of criticized assets, and other identified deficiencies or irregularities. An evaluation of the future condition of the bank is based on the analysis of—

- management's plans as expressed by operating plans, the capital plan, and other projections,
- factors such as competition and economic conditions, and
- the overall present condition of the bank.

The primary information for evaluating the present condition of a bank is the findings and conclusions of the assisting personnel. The examiner-in-charge should weigh the importance and significance of all criticisms, exceptions, and deficiencies in attempting to discover any unfavorable trends or situations. Through

review of the examination process, insight can be gained into such central issues as—

- present asset quality;
- current liquidity position;
- present capital adequacy;
- quality and performance of management;
- earnings performance, both past and present; and
- sources and applications of funds.

The examiner-in-charge usually will include remarks regarding those areas in the examination report. Although procedural areas of this manual deal specifically with each of those key items, the examiner-in-charge should utilize information from all phases of the examination. For example, when reviewing the bank's present capital position, the examiner-in-charge may use knowledge of the bank's asset and management quality to modify the conclusions of assisting personnel. The important point is that the examiner-in-charge is in the best position to assess all information provided by the examination process.

Factors affecting the future condition of the bank can generally be categorized as internal or external. The examiner's review of current condition flows naturally into an evaluation of internal factors affecting the institution's future prospects and condition. Among the items providing insight into future conditions are—

- earnings trends,
- successor management plans,
- the budget and/or profit plan,
- the capital plan, and
- any other internally generated projections or forecasts.

Many banks will not have formal written plans or projections. In such cases, the examiner-in-charge must obtain from senior management and/or the board of directors information on their plans for matters such as—

- growth and expansion,
- capital,
- changes in size and mix of assets, and
- changes in sources of funding.

The examiner should recommend that such banks take advantage of any externally available tools

to aid them in formulating plans and projections. In today's competitive market, strategic planning is a necessity for almost all banks. That is especially true in cases in which a bank is losing its market share and/or inefficiencies are depressing profitability.

If banks prepare budgets and/or profit plans, insight can be gained into the accuracy of balance-sheet and earnings projections by comparing actual and projected account balances. It also is beneficial to compare original projections to current projections to determine that adjustments are made on a timely basis. In situations where four- or five-year projections are made, banks often formulate several forecasts based on different sets of assumptions. In such a situation, the examiner should attempt to determine the bank's most likely future course.

The examiner should attempt to gain access to any official material or internal workpapers which document or illustrate the bank's rationale in planning its future. The goal is to review the institution's decision-making process.

Banks are turning increasingly to off-balance-sheet activities to deliver services, effect payments, generate income, and hedge interest-rate risks. Banks have introduced a wide variety of new products and services to complement their more traditional activities. Although such new activities are useful and profitable, they contain an element of risk. Many of those new activities involve a contingent liability or other risk which is not reflected on the bank's balance sheet and, indeed, may not even be fully recognized by the bank. The examiner should be aware of how the bank manages and controls its off-balance-sheet risks. Examples of off-balance-sheet activities include—

- electronic funds transfer systems,
- nontraditional lending activities (including the sale and servicing of mortgage- and government-guaranteed loans),
- innovative applications for standby letters of credit, and
- a wide variety of investment security activities (including futures and forwards, puts and calls, and short sales).

Risk can be distinguished primarily as credit risk, funding risk, rate risk, or risk resulting from internal control deficiencies. Examiners must be aware of the nature and extent of off-balance-sheet risks. The risks which affect capital, liquidity, and compliance with laws

should be evaluated for their potential effect on the safety and soundness of the bank.

In judging such controversial areas as capital adequacy and liquidity, the examiner should remember that, under ideal circumstances, management should be the expert on the bank's capitalization and liquidity position. Judgments on such matters should be generated internally, based on insight only management can possess. It is management that should know the bank's competitive situation, the economics of the service area, and the anticipated impact of those and other factors on its plans for growth and expansion. It is also management that has the greatest interest in the success of the bank. Accordingly, management and the directorate should choose a level of capitalization and liquidity consistent with their perception of the bank's situation rather than reacting to competitors and/or relying on pressures from regulators. However, specific judgments by the examiner are required, particularly in situations where a capital or liquidity position has fallen below what examiners consider to be acceptable norms. Objective justification for lower levels of capital or liquidity must be obtained and analyzed.

To properly evaluate the future prospects of a bank, the examiner must review external factors affecting the institution. Significant among those factors are the characteristics of a bank's area. Area refers to the bank's primary service area which is defined as that area from which the bank receives approximately 75 percent of its deposits. Demographics of the area generally are available and every bank should accumulate such information to aid in analyzing its current operations and planning for future operations. The absence of such information in an up-to-date form should be considered a deficiency. Included under examination procedures for this section is a listing of a minimum information required to ascertain the demographics of a service area. The examiner-in-charge should make sure that information is compiled and should analyze it to determine whether management expectations appear justifiable in the circumstances.

In dealing with competitive factors, the examiner should review or compute the share of market for the bank under examination. Continuing records in that area establishes an analyzable trend. Consideration also should be given to changes in the bank's statutory and regulatory environment, such as—

- changes in branching laws,
- changes in tax structure, and
- changes in laws affecting competition with other financial institutions.

Once the examiner has reached specific conclusions about the present condition and future prospects of the bank, or has noted serious deficiencies or detrimental trends, his or her conclusions and suggestions should be communicated to bank senior management, the board of directors, and the Federal Reserve Bank on a timely basis.

In formulating discussion and written comments, the examiner should avoid the appearance of second-guessing management. Therefore, conclusions, judgments, and recommendations should be based on objective information generated throughout the entire examination process.

Before preparing examination report comments regarding the overall condition of the bank, the examiner-in-charge should consider the reporting objective. Once it is determined that problems exist in a bank, the underlying causes must be identified. Those underlying causes as well as specific problems or deficiencies should be covered in the comments. For example, if deficiencies in written lending objectives or policies or noncompliance with sound policies have resulted in the acquisition of sub-quality assets, the examiner's comments must address both cause and effect. The total of criticized assets should be cited as evidence of the underlying problem and appropriate remedies, such as changing objectives or policies, should be suggested.

Examiners should remember that their ability to reach accurate conclusions regarding the overall present condition and future prospects of the bank and their skill in communicating the conclusions to management orally and in reports, will, to a great extent, determine the effectiveness of the entire examination process.

The examiner's conclusions regarding the overall condition of the bank are summarized in a composite rating assigned in accordance with guidelines provided under the Uniform Interagency Bank Rating System (CAMELS). The composite rating represents an overall appraisal of six key assessment areas covered under the CAMELS rating system: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. The summary or composite rating, as well as each of the assessment areas, is

delineated on a numerical scale of one to five, one being the highest or best possible score. Thus, a bank with a composite rating of one requires the lowest level of supervisory attention; while a five-rated bank has the most critically deficient level of performance and, therefore, requires the highest degree of supervisory attention. When appraising the six key assessment areas and when assigning a composite rating, the examiner weighs and evaluates all relevant factors. In general, these factors include the adequacy of the capital base, net worth, and reserves for supporting present operations and future growth plans; the quality of loans, investments, and other assets; the ability to generate earnings to maintain public confidence, cover losses, and provide adequate security and return to depositors; the ability to manage liquidity and funding; the ability to meet the community's legitimate needs for financial services and cover all maturing deposit obligations; and the ability of management to properly administer all aspects of the financial business and plan for future needs and changing circumstances. The assessment of management and administration includes the quality of internal controls, operating procedures, and all lending, investment and operating policies; compliance with relevant laws and regulations; and the involvement of the directors, shareholders, and officials.

Although the composite rating is based loosely on the average of the five component scores, the examiner's judgment can and should play a major role in its determination. Thus, the examiner must assess the severity, particularly the potential impact, of individual weaknesses on the present and future viability of the bank. Significant problems will provide sufficient basis for deviating from the numerical average approach to assigning the composite rating. However, whenever deviation from the numerical standards for the composite rating is necessary to reflect accurately the overall condition of the bank, the examiner must provide a full explanation of the reasons for such deviation.

Refer to the appendix for a complete discussion of the uniform rating system and considerations to be taken into account when using it to evaluate the condition of a bank.

SUBSIDIARIES OF BANK HOLDING COMPANIES

The composite rating of an individual subsidiary bank should be based on the condition of that

single entity. The quality of management and financial condition of the consolidated organization will be useful in assessing the prospects and understanding the operations of the bank being examined. However, banks with weaknesses requiring corrective action should be identified as such. Then, appropriate supervisory focus can also be made at the consolidated level. Also, banks should be identified by type on an individual basis rather than by applying the consolidated organization's characteristic to each bank. For example, the capital and condition of a community bank should be judged by community bank standards, not by multinational or regional standards, even if owned by such an organization. This recognizes that two consolidated organizations of similar size may be composed of entirely different types of banks. Proper evaluation of each bank component should lead a bank holding company inspector to the most appropriate conclusion on the condition of the consolidated entity.

FORMAL AND INFORMAL SUPERVISORY ACTIONS

As a general rule, supervisory action should be considered when other more routine measures such as formal discussions with a bank's principals or directors, and normal follow-up procedures, have failed to resolve supervisory concerns. The Uniform Interagency Bank Rating System clearly identifies the more serious problem banks and distinguishes them from banks whose weaknesses or deficiencies are such as to warrant a lower degree of supervisory concern.

For example, the application of prompt and effective remedial action may keep the condition of a composite 3 bank from deteriorating and the bank from becoming a problem institution. To ensure problem areas receive adequate attention, all weaknesses should be clearly defined and corrective measures properly structured. This objective may best be achieved through the execution of a memorandum of understanding between the bank's board of directors and Reserve Bank officials. A memorandum of understanding is not a formal written agreement as prescribed in the Financial Institutions Supervisory Act of 1966; it is a good faith understanding between the bank's directorate and the Reserve Bank concerning the principal problems and the bank's proposed remedies.

Banks rated composite 4 or 5 are clearly problem institutions that require close and constant supervisory attention. Unless specific circumstances argue strongly to the contrary, such banks will be presumed to warrant formal supervisory action, that is, a written agreement or cease-and-desist order, as provided for in the Financial Institutions Supervisory Act of 1966. In addition, the Board of Governors is also authorized to suspend and remove offending officers and directors of banks for certain violations and activities.

Although the decision to pursue formal or informal supervisory actions belongs to the Board of Governors or the Reserve Bank, the initial consideration and determination of whether action is necessary usually results from the examination process. Accurate and complete report comments which carefully delineate both the bank's weaknesses and deficiencies and management's existing or planned corrective measures will allow the Reserve Bank to make the most informed decision concerning appropriate supervisory action.

CIVIL MONEY PENALTIES

Under provisions of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95-630), the Board of Governors is authorized to assess civil money penalties for violation of the terms of a final cease-and-desist order and violations of—

- sections 19, 22, and 23A of the Federal Reserve Act (respectively, reserve requirements and interest-rate limitations; limitations on loans by insured banks to their executive officers, directors, and principal shareholders; and limits on loans by insured banks to their affiliates);
- the prohibitions of title VIII of FIRA against preferential lending to bank executive officers, directors, and principal shareholders based upon a correspondent account relationship; and
- a willful violation of the change in Bank Control Act of 1978 (12 USC 1817(j)).

In determining the appropriateness of initiating a civil money penalty assessment proceeding, the Board has identified a number of relevant factors (see *FRRS*, 3-1605). In assessing a

civil money penalty, the Board is required to consider the size of the financial resources and good faith of the respondent, the gravity of the violation, the history of previous violations, and such other matters as justice may require.

Examiners are responsible for the initial analyses on potential civil money penalties. Civil money penalties should be proposed for serious violations and for violations which, because of their frequency or recurring nature, show a general disregard for the law. After the examiner has reviewed the facts and decided to recommend a civil money penalty, he or she should contact the Reserve Bank for advice on proper documentation and any other assistance.

CRIMINAL REFERRAL PROCEDURES

On April 2, 1985, an agreement was signed by the federal financial institutions supervisory agencies and the U.S. Department of Justice that requires the agencies to work toward improving the federal government's response to white-collar crime in federally regulated financial institutions. The primary goal of the agreement is to ensure full cooperation in the sharing of relevant information among the agencies, subject to existing legal restrictions, so that all available information may be used in criminal, civil, and administrative proceedings. In keeping with that goal, the agreement sets forth procedures for the use of a uniform criminal referral form by all of the supervisory agencies and by the financial institutions regulated by them.

Summary of the Criminal Referral Form

The Federal Reserve System's version of the Criminal Referral Form, FR 2230, has been designed so that one form can be used for all reports. The form is to be used by all state member banks, bank holding companies, non-bank subsidiaries of bank holding companies, Edge Act and agreement corporations, U.S. branches and agencies of foreign banks, and Federal Reserve Banks in accordance with the Board's guidelines.

Suspected criminal violations of any section of the United States Code or state law (except

bank robbery) involving less than \$10,000 and not involving an executive officer, director, or principal shareholder of the institution can be reported by simply completing the first two pages of FR 2230. If the suspected criminal violation involves an actual or probable loss of \$10,000 or more or, in any case, involves an executive officer, director, or principal shareholder of the institution, all items on the form must be completed. The instructions on the Criminal Referral Form direct the filing institution to send a copy to the local FBI office, the nearest office of the U.S. attorney, the Reserve Bank, and, in certain instances, the Secret Service.

The Criminal Referral Form describes the mandatory and optional reporting requirements, which, along with applicable dollar thresholds, have been changed. In outline form, they are as follows:

- A Criminal Referral Form must be filed—
 - if a financial institution suspects criminal activity by its employee, officer, director, or agent (e.g., an insider) involving any amount;
 - if a financial institution suspects criminal activity involving a loss of \$1,000 or more, the financial institution can identify a suspect, and the suspect is not an employee, officer, director, or agent (e.g., a non-insider);
 - if a financial institution suspects criminal activity involving a loss of \$5,000 or more and it cannot identify a suspect; or
 - if a financial institution suspects criminal activity involving a violation of the bank secrecy and related money laundering laws and regulations.
- A Criminal Referral Form may be, but is not required to be, filed—
 - if a financial institution suspects criminal activity involving a loss of less than \$1,000, the financial institution can identify a suspect, and the suspect is not an employee, officer, director, or agent of the financial institution (e.g., a non-insider); or
 - if a financial institution suspects criminal activity involving a loss of less than \$5,000 and it cannot identify a suspect.

The Enforcement Section of the Division of Banking Supervision and Regulation has primary responsibility for the criminal referral

process, including coordination with Federal Reserve Banks, U.S. attorneys, the Department of Justice and the FBI, and tracking and recording of all criminal referrals. "SR" letters have been distributed within the Federal Reserve System, including SR-85-22 (FIS), SR-86-7 (FIS), and SR-88-9 (FIS), and reference should be made to them in connection with any inquiry in this area.

Examination Objectives

To determine if the institution has established internal procedures to ensure the prompt and accurate submission of all reports of suspected criminal activity to appropriate authorities.

Examination Procedures

1. Determine whether the institution has a policy of reporting suspected criminal activity.
2. Determine how the policy has been communicated to officers and employees.
3. Determine whether a person(s) or department in the bank has been designated as being responsible for the filing of the Criminal Referral Form, FR 2230.

Reporting Suspected Criminal Violations

If, during the course of an examination, an examiner uncovers a situation that is known or suspected to involve a criminal violation of any section of the United States Code or state law and no referral of the matter has been made by the bank or an inadequate referral was made, details should be reported immediately to the Reserve Bank. If the situation warrants a telephone call to the Reserve Bank, this should be done and followed by a detailed report. The report should be in the form of a memorandum, and must be written in such a way as to fully apprise the Reserve Bank of the situation. All of the information contained in the Criminal Referral Form, FR 2230, should be embodied in the

memorandum. Copies of the pertinent exhibits should be attached.

The examiner's report should be confined to clear-cut statements of fact and must not contain opinions as to the probability of indictment, conviction, or related matters. In all reports and workpapers, the examiner should be as specific as possible (e.g., rather than indicating "it is reported" or "the bank indicates") and he or she should identify who reported the matter and how it occurred. On each transaction that is to be reported, copies of all documentation should be obtained and placed in a separate file detailing who handled the transaction in the bank. The reporting of the matter within the bank should be chronologically referenced throughout the documentation. The copies of documentation should be initialed and dated by the examiner in case the original is destroyed. The documentation is extremely important to proving a particular transaction.

The examiner's initial notification of suspected criminal violations to the Reserve Bank and the transmittal of data should be accomplished without informing bank personnel. Only the Reserve Bank or a designated representative should inform bank personnel or its board of directors of a suspected criminal violation that had not been reported by the bank or inadequately reported by bank personnel.

After reviewing the information submitted by the examiner, the Reserve Bank will decide whether the facts support the examiner's contention that a possible unreported violation of the criminal statutes exists. If the Reserve Bank discovers that in a particular instance a bank failed to report the suspected criminal violation using the Criminal Referral Form, FR 2230, or made an inadequate referral, and upon request, still fails to make a report, the Reserve Bank itself must then complete a Criminal Referral Form, FR 2230.

Appropriate comments relating to a bank's failure, if any, to make all necessary criminal referrals in an accurate and timely manner should be made in the report of examination of the bank. Repeated or serious problems in this area should be directed through the Reserve Bank to the Enforcement Section of the Division of Banking Supervision and Regulation.

Overall Conclusions Regarding Condition of the Bank

Examination Objectives

Effective date March 1984

Section 5020.2

1. To reach conclusions regarding the present condition of the bank.
2. To reach conclusions regarding the future prospects of the bank.
3. To determine the bank's ability to meet demands in the ordinary course of business or reasonably unusual circumstances.
4. To determine the bank's adherence to safe and sound banking practices.
5. To formulate recommended action, when appropriate, based on those conclusions.
6. To communicate conclusions and recommendations both orally and in the examination report.

Overall Conclusions Regarding Condition of the Bank

Examination Procedures

Effective date May 1988

Section 5020.3

Inasmuch as the following procedures are largely dependent on information generated from all phases of the examination, the examiner-in-charge should complete this program during the final stages of the examination. The completion of this program generally can be best accomplished during the review of the workpapers.

1. Analyze any available information concerning the characteristics of the area in which the bank operates to determine the existence of any unusual situations, any significant trends, the potential impact on the bank of any expected changes or any other significant information which could be detrimental to the bank. The bank should be consulted for sources of information which might include the most recent census data or data generated by organizations, such as the Chamber of Commerce. In analyzing the bank's trade area:
 - a. Consider density, income levels, general age group of the residents. Determine if there are significant changes in any of the above factors.
 - b. Determine the predominant living accommodations in the area (owner occupied vs. rental), price/rent levels and availability of residential units. Determine whether there are any major residential construction projects, re-zoning or conversions of single to multiple units which will have a significant effect on the bank.
 - c. Consider the types of industry and the number of firms in the area with emphasis on determining concentrations or seasonality. Investigate any major labor contract expirations, competitive factors or other significant factors which could have a negative effect on the community.
 - d. Consider the types of major products, available markets and present and projected prices for the products.
 - e. Consider any expected changes in street facilities which will significantly affect bank's accessibility/convenience. Determine the availability of public transportation.
 - f. Review the number and types of institutions that provide similar financial services in the community. Consider the aggressiveness, hours of business and additional services offered by competitor institutions.
- g. Determine the effect of government employment or dependence on government contracts on the community.
- h. Consider the condition of the national economy with particular attention to the rate of inflation, national vs. local unemployment, current interest rates and government fiscal and monetary policy. Specific problems, peculiar to a particular area should be investigated more thoroughly.
2. Review comments and conclusions contained in the workpapers which were generated throughout the examination and perform the following:
 - a. Compile all criticisms, exceptions and deficiencies.
 - b. Determine the existence of contradictory conclusions.
 - c. Consider the relative significance of criticisms, exceptions, deficiencies and conclusions and segregate important criticisms for the final review with management and for incorporation into the report of examination.
3. Based on procedures performed and conclusions contained in the workpapers, answer the following specific questions. These questions are intended as guidelines to the examiner-in-charge in formulating overall conclusions regarding the condition of the bank and should be augmented by the examiner's knowledge of the bank. "Yes" answers, in many instances, evidence the existence of a "leading" indicator of deterioration of bank soundness. For any question with a "yes" answer, specify any mitigating circumstances in the comments column. Sub-question answers are for information purposes.
 - a. *Asset Quality*
 - Is there an increasing ratio of criticized assets to total capital?
 - If so, is it indicative of adverse economic conditions, poor credit

judgment, or other factors (specify)?

- Has there been a material increase in the quantity of non-earning assets?
- Is there any abnormally increasing trend of past-due loans and/or interest earned but not collected?
 - If so, is it indicative of general economic conditions in the bank's trade area
 - Is the trend indicative of a weakening of collection policies and procedures, a slackening of credit standards, the bank's failure to recognize an asset which should be in a non-earning category, or is it caused by some other factor?
- Has a trend developed wherein the bank assumes increased risk without receiving increased rewards?
- Do the portfolios exhibit high concentrations in specific industries?
 - If so, do the concentrations represent a significant actual or contingent problem?
- Has the overall quality of assets deteriorated since the last examination?
 - If so, is the deterioration recognized by management and the board of directors? Can the deterioration be attributed to factors beyond the control of management or the board of directors, such as a change in the general economic conditions of the bank's service area?
 - If deterioration results from internal factors, such as lowering of credit standards or poor credit judgment, have steps been taken by management to effectively reverse negative trends?

b. *Quality of Management*

- Has the executive management changed since the last examination?
 - If so, is the change detrimental to the bank?
- Has there been any change in the general banking philosophy of executive management?
 - If so, is that detrimental to the bank?

- Do key bank officers have educational and/or experience levels below that considered minimal in the circumstances?
- Is there any tendency toward over reliance on essentially untrained and unskilled clerical staffs?
- Is there a large disparity between the compensation level of the chief executive officer and other members of executive management?
 - If so, is that disparity an objective indication of disproportional domination of the bank's affairs?
- Has the bank instituted any systems which directly reward managers for increasing bank income from assets or services subject to their control?
 - If so, has the bank failed to institute necessary control and audit procedures to prevent abuses?
- Has the bank failed to institute any programs which would give officers a vested interest in remaining with the bank?
 - If so, would the institution of such a program offer a workable solution to an actual or potential officer turnover problem?
- Is the bank's strategic and operational planning inadequate?
- Is the board of directors unresponsive to internal or external suggestions for improvement in the bank?
- Are the following conditions present?
 - Infrequent meetings of board of directors.
 - Infrequent meetings of committees of the board.
 - Infrequent management committee meetings.
 - A directorate which is split into distinct voting groups.
 - If so, are directors viewed as failing to perform their functions adequately?
- Is the quality of management deemed inadequate to conduct the affairs of the bank in a reasonable and safe manner?
- Are training programs and compensation increments deemed inadequate to attract and retain a staff capable of providing management succession?

c. Earnings

- Are earnings static or moving downward as a percentage of total resources?
- Is there a trend of decreasing income before security gains and losses as a percentage of total revenues?
 - If so, is such a trend expected to continue?
 - If so, has management determined causes for any deterioration and taken action to reverse the negative trend?
- Has the ratio of operating expenses to operating revenues been increasing?
- Are earnings trends consistent?
- Has a decreasing spread between interest earned and interest paid developed?
- Are the bank's earnings significantly vulnerable to changes in interest rate levels?
 - If so, what are management's plans and prospects for altering the vulnerability?
- Are there any significant structural changes in the balance sheet which may impact earnings?
- Has the bank experienced increasing actual loan losses and/or loan loss provisions?
- Is there any evidence that sources of interest and other revenues have changed since that last examination?
 - If so, is that attributed to an unsound emphasis for increased earnings?
- Are earnings deemed inadequate to provide increased capitalization commensurate with the bank's growth?

d. Capital

- Has the bank been unable to maintain a normal growth rate for capital?
- Do the ratios of loans to capital, deposits to capital or total assets to capital exhibit a trend to abnormal increases?
- Is capital deemed inadequate to support the present volume of business, including the volume of off-balance-sheet activities, in view of the amount

of criticized assets, the competency of management, etc.?

e. Liquidity

- Is there a trend toward decreasing bank liquidity?
- Has the bank been forced to increase abnormally dependence on borrowed funds to support existing assets?
- Does the bank depend excessively on purchased funds?
- Is there a trend toward investing interest sensitive liabilities in non-interest sensitive assets?
- Do the present quantity and maturity of non-interest sensitive assets represent a dangerous or potentially dangerous situation?

f. Off-Balance-Sheet Risk

Loans Sold or Serviced

- Is the bank involved as the lead or agent in loan participations, syndications, or servicing activities to the extent that management expertise is inadequate, or to the extent that the volume exceeds the level which management can capably handle?
- Does the bank's record of pending or threatened litigation indicate any instances where the bank, as lead or agent in a loan participation or syndication, has willfully misrepresented the credit to the other participants, or otherwise acted with gross negligence in handling the credit?
 - If so, is there any indication that the participants intend to hold the bank liable for any loss incurred on the credit?
- Did the examination reveal a practice of improper origination and packaging of loans sold or serviced which could cause:
 - The bank being compelled to repurchase the package, or
 - In the case of government guaranteed loans, the complete or partial dishonor of the guaranty?

- Has the bank previously repurchased participations when a loss was incurred, although it was not legally required to do so?

Letters of Credit

- Is there a trend toward increasing the issuance of standby letters of credit or other similar credit instruments?
 - If so, has the bank failed to consider the full impact of funding a significant percentage of those instruments?
- Are letters of credit excluded from the bank's internal loan review program?
- Does the internal evaluation of letters of credit include consideration of country and currency risk as well as credit risk?
- Is there a declining trend in the credit quality of letters of credit?
- Are standby letters of credit issued for purposes not covered in the bank's lending policy, or for which management does not have the expertise to handle?
- If not authorized in the bank's lending policy, were proper approvals obtained prior to issuance?

Wire Transfer Department

- Do internal control deficiencies in the wire transfer department pose a threat for large potential losses through fraud or error?
- Are there internal control deficiencies in the receiving and conveying of messages for other parties which may expose the bank to litigation for improper handling of the messages?

Data Processing Department

- Are internal controls inadequate in the bank's data processing area?
 - Are control deficiencies such that the accuracy and/or timeliness of data is questionable?
 - Are deficiencies such that the bank, in performing data processing services for others, could be liable for

misplacement or other improper handling of source data?

- Are the bank's computer hardware and software systems inadequate to support the present and anticipated level of operations?
 - Are deficiencies such that hardware and systems will require replacement or upgrading in the short term?

Settlement Procedures

- If the bank is a member of CHIPS, Fedwire or other clearinghouse system, are procedures inadequate for the proper monitoring of incoming and outgoing wire transfers so that the bank is occasionally unprepared for settlement?
 - Would earnings be significantly affected if the immediate acquisition of funds is required to meet settlement?
 - Is the bank aware of the creditworthiness and ability of the other clearinghouse participants to make settlement?
- Are customers' daylight overdrafts allowed to exceed established credit limits or are they otherwise being improperly monitored?
- Is there a history of daylight overdrafts which have not been covered before the close of business?

Investment Securities

- Are there significant internal control deficiencies associated with the bank's handling of "when issued" trades, futures contracts and forward placements?
 - Is management's knowledge of interest rate hedging techniques insufficient to support such activity?
- Does the bank act as agent on securities or repurchase agreement transactions?
 - If so, does the customer agreement specifically designate liability for failure or performance?

Miscellaneous

- Did the analytical review of income and expenses disclose any additional off balance sheet activities for which management does not exhibit the necessary expertise and does not have adequate internal controls to handle the service?
- Does a review of legal actions against the bank indicate any pattern of practices which are caused by deficient internal controls?
 - If so, have the deficiencies been corrected?
- Is the potential liability arising from pending litigation considered significant in terms of capital adequacy and liquidity, considering the level of other contingent liabilities?
- Are any of the bank's affiliates or subsidiaries experiencing unprofitability or liquidity problems which may affect the soundness of the bank?
- Are operating lease liabilities and annual lease payments significant in terms of the bank's other funding requirements?
- Is potential restitution resulting from Truth in Lending Act violations significant relative to capital and liquidity?
- Is the bank's level of loan commitments, standby letters of credit, commitments to purchase securities and futures/forward contracts imprudent in light of overall circumstances within the bank?

g. *Internal Controls and Audit Procedures*

- Have internal controls deteriorated since the last examination?
- Do any of the following exist at the bank?
 - Low compensation level of internal auditors.
 - Internal or external auditor who reports directly to other than the board of directors or a committee thereof.
 - Internal auditors who perform original work versus monitoring the efforts of others.

- Abnormally low percentage of internal auditors to total personnel.
 - Inadequate training or supervision of internal auditors.
 - Questionable independence of external auditors.
 - Inadequate management response to deficiencies cited by auditors.
- If so, do these or other pertinent factors indicate a less than adequate situation in internal or external audit?
- Are internal controls and audit programs deemed inadequate?

h. *Ownership*

- Have there been significant changes in ownership since the last examination?
 - If so, could the change be detrimental to the soundness of the bank?
- Does any situation exist wherein one individual is capable of controlling the bank?
 - If so, is that detrimental to the bank's soundness?
- Is there any evidence of an impending proxy fight?
- Are ownership interests using borrowed funds to carry the bank's stock?
 - If so, is there an indication that undue pressure for increased earnings is being applied by the owners?
 - If such pressure is being applied, does that have a detrimental impact on the general characteristics of asset composition, as it exists, and asset composition, as it is expected to develop?

i. *Miscellaneous*

- Does the bank exhibit a high dependence on purchasing or participating in loans originated and managed by others?
 - If so, is that attributable to a lack of local loan demand or to a failure of the bank to service its trade area?
- Is there an increasing trend toward making loans and/or accepting deposits from outside of areas in which the bank maintains offices?

- If so, does management and the board fully understand the risks inherent in such activity?
 - Has a trend toward increasing advances to affiliated companies developed?
 - If so, does that presently represent a dangerous situation?
 - Has the bank experienced an abnormally fast rate of growth?
 - If so, is that growth reasonable and does it therefore, have no significant impact on future soundness, based on:
 - Economic conditions within the trade area?
 - The bank's increased marketing efforts?
 - Offering improved services to the community?
 - Other factors?
 - If so, is the bank's management team capable of adequately administering the growth?
 - Does the bank have an imprudent investment in fixed assets?
 - Does the bank depend to an excessive degree on a small, local economy, which is subject to cyclical swings due to local conditions and industries, as opposed to mirroring national economic trends?
 - If so, is that a source of criticism or does it represent a potentially dangerous situation?
 - Are there large fluctuations in the stock price of the bank or its parent?
 - If so, is management unable to discern a cause for such fluctuations?
 - Is management giving inadequate attention to compliance with laws and regulations?
4. Have all questions raised by the UBPR specialist been explored?
 5. Complete workpapers.
 6. Organize general conclusions regarding the present condition of the bank and:
 - a. Correlate plans, projections, forecasts, and budgets with present conditional aspects, area characteristics, and management capability to determine which of the goals the bank has set you believe to be unattainable.
 - b. Project the future condition of the bank based on its present financial condition, the economic expectations of the bank, the quality of management, director supervision and any other relevant factors.
 - c. Formulate recommendations for management to consider when they initiate corrective or preventative action.
 7. Conduct a final summary discussion with management to include:
 - a. Criticisms noted during the examination.
 - b. Conclusions reached about the bank in general.
 - c. Expected future condition:
 - Management's view.
 - Examiner's view.
 - d. Review of other potential problems.
 - e. Planned corrective action:
 - Examiner recommendations.
 - Management commitments.
 8. Update "Management Assessment" conclusion to add any relevant information obtained as a result of procedures performed in this program.
 9. Prepare recommendations for any necessary supervisory action.
 10. Perform the following steps for suspected violations of criminal statutes:
 - a. Determine that a Criminal Referral Form, FR 2230, has been filed, if appropriate.
 - b. Notify the Reserve Bank by telephone immediately if warranted by the type and seriousness of the suspected violation.
 - c. Prepare a separate memorandum to the Reserve Bank containing sufficient detail to be fully informative.
 - d. Prepare brief comments for the confidential section of the report of examination citing the date of the memorandum to the Reserve Bank.
 - e. Segregate, identify, initial and date all appropriate workpapers and transmit them to the Reserve Bank making certain that the workpapers are factual, complete and do not contain expressions of examiner opinion.
 11. Write, in appropriate report form, all comments and conclusions to be included in the confidential section of the examination report.
 12. Update the workpapers with any information that will facilitate future examinations.

INTRODUCTION

The board of directors plays an essential role in the management of a bank's operations and is directly responsible for the soundness of the bank. As a result, in some cases, it is useful for Federal Reserve examiners and/or officers to meet with boards of directors. These meetings provide examiners with the opportunity to inform directors of examination findings, discuss the bank's plans and prospects with the board, and highlight important supervisory issues, particularly in cases that may require initiation of informal or formal supervisory actions. Meetings with boards of directors also provide examiners with a limited opportunity to ascertain the directors' knowledge of and interest in the bank's operations.

If Federal Reserve examiners believe it is necessary or desirable, they may conduct meetings with directors immediately after the on-site portion of an examination and before an examination report is completed and distributed. Such meetings are particularly encouraged when they can be conducted as part of regularly scheduled board meetings that coincide with the on-site examination.

When a bank is determined to be a problem or has exhibited significant deterioration, Federal Reserve examiners must conduct meetings with the directors. Such meetings require the participation of Federal Reserve officers and are typically conducted after the report of examination has been distributed.

GENERAL GUIDELINES

Meetings with boards of directors must be tailored to the individual circumstances of each bank, as well as to the Reserve Bank's supervisory objectives. As a result, uniform procedures for the conduct of these meetings cannot be specified. Nonetheless, the following guidelines should be considered when planning and conducting meetings with bank directors.

Content of Meetings

When participating in meetings with bank boards, examiners should present only informa-

tion needed by, or relevant to, the directorate. This information varies depending on the bank's circumstances; however, examiners should inform the board of the examiner's assessment of the bank's condition; highlight any deficiencies requiring the board's attention; and solicit the board's views on the bank's condition, operations, and prospects. In addition, examiners should obtain the board's commitment to address promptly the deficiencies identified in the examination. Examiners should encourage inquiries and discussions with the directors to learn more about the directors' roles and performance and to foster a good working relationship with them.

Data supporting the examiner's conclusions and comments should be prepared and presented to board members in a professional manner. Slides, handouts, and other visual aids are encouraged. Comparative figures and ratios from previous and present examinations should be reviewed prior to the meeting, with handouts and visual aids highlighting adverse trends.

Outlines for Meetings

Examiners should prepare detailed outlines of each meeting's discussion points and goals. Following is a sample outline that examiners may use as a guide to prepare for meetings with directors. It is not all-inclusive, and examiners should not be limited by its content in developing their own presentations. Generally, comments on these items are warranted when concerns have arisen during the current examination, or when significant changes—positive or negative—have occurred since the last examination.

- I. Introductory remarks by Federal Reserve Bank official or examiner
 - A. Federal Reserve Bank policy regarding board meeting
 - B. Purpose of the meeting
- II. Examiner's presentation
 - A. Duties and responsibilities of directors
 1. Effectively supervise the bank's affairs
 2. Select competent management
 3. Adopt and follow sound, written policies and objectives

4. Avoid self-serving practices
5. Be informed of the bank's financial condition and management policies
6. Maintain reasonable capitalization
7. Observe banking laws and regulations
- B. Adequacy and effectiveness of policies and procedures
 1. Lending
 2. Investments
 3. Asset/liability management
 4. Personnel
 5. Operations
- C. Adequacy and accuracy of bank's reporting systems
 1. Reports of the board and committees
 2. Management reports to the board
 3. Management information systems
 4. Regulatory reports
- D. Condition of the bank/results of the examination
 1. Asset quality
 2. Violations of law, evidence of self-dealing
 3. Capital
 4. Management
 5. Liquidity
 6. Earnings
 7. Internal controls and audit coverage
 8. Future prospects
 9. Relationships with bank holding company
- E. Required corrective action on problems and board commitment
- III. Summary of overall conclusions
- IV. Questions from the board

Procedural Issues

In general, meetings with the full board are preferable. In certain cases, however, a Reserve Bank may determine that meeting with a board committee, such as the executive or audit committee, will fulfill the Reserve Bank's supervisory objectives. Any person connected with the bank, such as an attorney, auditor, or holding company representative, may attend the board of directors meeting at which the overall findings and conclusions of the examination are discussed. The attendance of any such party should be noted in the minutes of the meeting. However, the examiner may excuse such persons during any portion of his or her presentation if deemed appropriate. Attendance by

honorary directors to participate in discussions and review the examination report is also permitted.

Generally, at least one member of a Reserve Bank's official staff is expected to represent the Federal Reserve at meetings with directors of banks. However, for meetings with the directors of banks that have less than \$500 million in assets, Reserve Banks are granted the discretion to have senior examination staff represent the Reserve Bank. The participation of Reserve Bank presidents in meetings with directors is left to the discretion of the Reserve Bank.

To the extent possible, meetings with the boards of directors of state member banks should include representatives of the relevant state banking authority. A meeting with the directors of a bank that is owned by a holding company may be held at the same time as a meeting with the directors of the holding company, when appropriate.

Whenever a meeting is held between an examiner and a board, the examiner should prepare written comments on the meeting for examination workpapers.

MEETINGS WITH BOARDS OF PROBLEM BANKS AND BANKS EXHIBITING SIGNIFICANT DETERIORATION

When an examination reveals that a bank has significant problems, Federal Reserve policy requires that a meeting be held with its board of directors. The policy further requires that a written summary of examination findings—separate from the complete examination report—be distributed to each director in such cases. A senior Reserve Bank official also must participate in communicating and presenting examination findings on problem banks to their boards of directors. This policy's objective is to ensure that each director of a state member bank considered to be a problem or to have a significant weakness clearly understands the nature and dimension of the problems, as well as the joint and several responsibility of the directors to effect correction.

Criteria Requiring Meetings with Problem Banks

A meeting with the board of directors is to be

held after any full-scope examination in which a state member bank is assigned a CAMELS composite rating of 4 or 5. A meeting is also required if a bank is rated composite 3 and its condition appears to be deteriorating or has shown little improvement since a previous examination in which it received a composite 3 rating. Furthermore, a meeting should be held after a targeted examination if deemed appropriate and desirable by the Reserve Bank. An official of the Reserve Bank and the examiner-in-charge should also meet with a board if any of the following conditions exist:

- The bank is entering into a formal written agreement with the Federal Reserve, a cease-and-desist order is being issued, or the bank is being placed under a memorandum of understanding.
- The bank is already operating under a supervisory action but is in noncompliance with significant provisions or has experienced significant deterioration since the action was initiated.
- Self-serving activities or other unsafe and unsound practices exist in the bank.
- Any other condition or practice that places, or could place, the bank in a seriously weakened or extended condition has been identified during the examination.
- inadequacies in policies, practices, and reporting systems necessary for proper risk management and organizational administration
- lack of well-documented lending, collection, investment, asset/liability management, and risk-management policies or the failure to ensure that such policies are being followed
- failure of management to address previously discussed deficiencies
- lack of reporting systems sufficient to keep senior management and the board of directors fully informed
- failure of the board of directors to ensure the active management of the organization

MEETINGS WITH BOARDS OF MULTINATIONAL AND MAJOR REGIONAL BANKS

A meeting with the board of directors is required after every full-scope examination of a multinational organization or major regional organization with assets in excess of \$5 billion. Reserve Banks also are encouraged to conduct such meetings after every full-scope examination of a regional bank with assets in excess of \$1 billion.

MEETINGS WITH BOARDS OF DE NOVO BANKS

After the approval of a membership application, but before a de novo bank is opened, Reserve Bank staff should meet with the full board of directors to discuss applicable statutes, regulations, policies, and supervisory procedures. As with all meetings with directors, the agenda for this meeting should be tailored to the individual circumstances of the bank. At a minimum, the Reserve Bank should apprise the directors of their responsibilities and emphasize their need to adhere to sound operating policies.

DIRECTOR'S SUMMARY OF EXAMINATION FINDINGS

In addition to the report of examination, Federal Reserve Banks must provide written reports to directors summarizing the examination findings for all banks rated composite 3, 4, or 5, and for those rated composite 1 or 2 that show signs of

Additional Guidelines

Senior Reserve Bank officials are expected to participate in meetings with the directors of problem banks, with the seniority of the participating official determined by the condition and size of the bank. The larger the organization or the more serious its problems, the more senior the Federal Reserve official should be.

A meeting with the board of directors of a problem or deteriorating bank should include a formal, structured presentation with a clear statement that the bank is considered a "problem institution" or is about to become a problem institution if existing conditions deteriorate. The presentation should further make clear the nature of problems confronting the bank, citing examination findings such as the following:

- deficiencies in capital, asset quality, earnings, or liquidity
- violations of law

significant deterioration in condition or apparent violations of law. The summary reports should focus on identified problems—rather than on the strength of the organization—and present the bank’s deficiencies succinctly and clearly. In all cases, the types of actions directors and management should take to address identified problems should be specifically stated. Directors of institutions rated 4 or 5 are to be told their banks are “problem” institutions that warrant “special supervisory attention.” Directors of banks rated 3 are to be informed that the bank’s condition is “not satisfactory,” that the bank is subject to “more-than-normal supervision,” and that the bank may become a “problem” if weaknesses are not addressed adequately.

Summary reports should emphasize the responsibilities of the directors to ensure that corrective actions are taken to address all deficiencies noted in the pages of the full bank examination report entitled “Matters Requiring Board Attention” and “Examination Conclusions and Comments.” In addition, the organization, style, and content of the summary report

should be similar, if not identical, to the text of these report pages.

Summary reports should be sent directly to the bank’s management for distribution to each director. The transmittal letter to the bank should state the report is a summary of identified problems and contemplated supervisory actions and direct bank management to distribute the summary report to each director. The letter should further instruct each director to read the report, sign the introductory statement attesting to having read the report, and return the report to management. Management should keep copies of the directors’ signed statements on file, but should destroy all but one file copy of the summary report itself.

The summary report must be completed and distributed before any meeting between Reserve Bank officials and the bank’s board of directors, to provide the directors with prior notice of deficiencies to be discussed. Reserve Banks should also make every effort to distribute the complete examination report to management before meeting with a board of directors.

Meetings with Board of Directors

Examination Objectives

Effective date March 1984

Section 5030.2

1. To foster a better understanding of the respective roles of directors and examiners.
2. To inform the directors of the examination scope and the bank's condition.
3. To obtain information concerning future plans and proposed changes in bank policies that may have significant impact on the future condition of the bank.
4. To reach an agreement on any significant problems.
5. To obtain a commitment to initiate appropriate corrective action.

Meetings with Board of Directors

Examination Procedures

Effective date March 1984

Section 5030.3

1. Inform management that a meeting will be held with the board of directors. State the Federal Reserve Bank's policy and the purpose of the meeting and establish a tentative date.
2. Finalize the time and place of the meeting when confident that a thorough understanding of the condition of the bank will be developed. If the meeting is to be a "special meeting" resulting from serious areas of concern, perform procedure 7.
3. Develop an outline of matters to be covered at the meeting by reviewing results of the examination.
4. Prepare supportive data for the meeting by:
 - a. Compiling a list of comments and criticisms.
 - b. Preparing schedules of comparative figures for discussion.
 - c. Affirming that the bank has responded adequately to Reserve Bank requests.
 - d. Preparing questions to elicit opinions and attitudes of individual board members.
5. Prepare a brief formal agenda for the meeting and reproduce enough copies to distribute to participants.
6. If it is decided that a meeting will be held:
 - a. Communicate with Reserve Bank office to:
 - Notify office staff of the proposed date and place of the meeting. (Confirm time and place when final.)
 - Determine whether a Reserve Bank official will attend.
 - Determine whether the Reserve Bank official has suggestions for the agenda.
 - b. Submit a copy of the agenda and outline in advance to the Reserve Bank official.
 - c. Inform directors that the following must be submitted to the Reserve Bank office:
 - A copy of a board resolution stating corrective action.
 - A written plan for corrective action to be forwarded within a specified time period.
 - Periodic progress reports.
7. For "special meetings" resulting from serious problems:
 - a. Communicate with the Reserve Bank to:
 - Notify office staff of the proposed date and place of the meeting.
 - Determine whether a Reserve Bank official will attend.
 - Determine whether the Reserve Bank official has suggestions for the agenda.
 - b. Confirm the final time and place of the meeting with the Reserve Bank office.
 - c. Prepare any special supporting data for the meeting, such as areas of noncompliance with memorandums of understanding or cease and desist agreements or orders.
8. Conduct the board meeting in accordance with the agenda and previously prepared outline, being certain to discuss:
 - a. Major criticisms noted during the examination.
 - b. Conclusions reached about the bank in general.
 - c. Expected future conditions.
 - d. Potential problems.
 - e. Planned corrective action:
 - Examiner's recommendations.
 - Management's commitments.
 - Director's commitments.
9. Obtain a definite agreement or commitment from the board that appropriate corrective action will be taken.
10. Prepare a memorandum covering the meeting with the board to include, as a minimum:
 - a. The time and place of the meeting.
 - b. The directors and guests in attendance.
 - c. The matters subject to criticism that were reviewed.
 - d. A summary of the general discussion on the matters presented to the board.
 - e. A summary of the director's reaction to the situation and any commitments obtained from them.
11. Request that copies of the minutes of the board meeting be forwarded to the Reserve Bank and the examiner-in-charge.

INTRODUCTION

The Federal Reserve Board has a broad range of enforcement powers over both domestic and foreign financial institutions and over the individuals associated with them. Generally, formal or informal enforcement actions are taken after the completion of an on-site bank examination. These examinations include commercial, trust, electronic data processing, consumer, or other types of examinations. Formal or informal enforcement actions may also be taken when the Reserve Bank becomes aware of a problem at a bank that warrants immediate attention and correction.

Many of the Board's enforcement powers were initiated or enhanced by title IX of the Financial Institutions Reform, Recovery, and Enforcement Act and the Bank Fraud Act.¹ The Board's jurisdiction over individuals associated with financial institutions—"institution-affiliated parties"—includes any officer, director, employee, controlling shareholder, or agent of a financial institution, and any other person who has filed or is required to file a change-in-control notice. The term "institution-affiliated party" also includes any shareholder, consultant, joint-venture partner, or any other person who participates in the conduct of the affairs of the financial institution, as well as any independent contractor, including attorneys, appraisers, and accountants, who knowingly or recklessly participates in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution.² The Board's jurisdiction over an institution-affiliated party extends for up to six years after the party's resignation, termination of employment, or separation caused by the closing of a financial institution, provided that any notice (such as a notice of intent to remove from office and of

prohibition) is served on the party before the end of a six-year period.

FORMAL SUPERVISORY ACTIONS

The following statutory tools are available to the Board in the event formal supervisory action is warranted against a state member bank or any institution-affiliated party. The objective of formal action is to correct practices that the regulators believe to be unlawful, unsafe, or unsound.³ The initial consideration and determination of whether formal action is required usually results from examination findings. Workpaper documentation is important to support all recommendations for both formal and informal actions.

Types of Corrective Actions

Generally, under 12 USC 1818, the Board may use its cease-and-desist authority and civil money penalty authority against any state member bank and any institution-affiliated party that meets the statutory criteria for issuing such an order. Prohibition and removal actions may be taken against any institution-affiliated party who meets the statutory criteria to bring such an action.

Cease-and-Desist Orders

Generally, under 12 USC 1818(b), the Board may use its cease-and-desist authority against a state member bank and any institution-affiliated party when it finds that a bank or party is engaging, has engaged, or is about to engage in a violation of law, rule, regulation, a condition imposed in writing by the Board in connection with the granting of any application or any written agreement, or in an unsafe or unsound practice in conducting the business of the insti-

1. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) was enacted on August 9, 1989; the Comprehensive Thrift and Bank Fraud Act (the Bank Fraud Act) was enacted on November 27, 1990.

2. The Board is authorized to issue regulations further defining which individuals should be considered institution-affiliated parties. Similarly, the Board may determine whether an individual is an institution-affiliated party on a case-by-case basis.

3. An unsafe or unsound practice is defined as any action that is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance fund.

tution. Under 12 USC 1818(s), the Board must initiate a cease-and-desist action against a bank when it has failed to establish Bank Secrecy Act procedures required by the Board's Regulation H or has failed to correct any previously noted deficiencies related to these procedures.

A cease-and-desist order may require the bank or person subject to the order to (1) cease and desist from the practices or violations or (2) take affirmative action to correct the violations or practices. Affirmative actions might include returning the bank to its "original condition" before the practice or violation. Affirmative actions may also include restrictions on growth, debt, and dividends; the disposition of any loan or asset; rescission of agreements or contracts; employment of qualified officers or employees; restitution, reimbursement, indemnification, or guarantee against loss if the bank or person was unjustly enriched by the violation or practice, or if the violation or practice involved a reckless disregard for the law or applicable regulations or a prior order; and any other action the Board determines to be appropriate.

When Board staff, in conjunction with the appropriate Reserve Bank, determines that a cease-and-desist action is necessary, the bank or person is generally given an opportunity to "consent" to the issuance of a cease-and-desist order without the need for the issuance of a notice of charges and a contested administrative hearing. Generally, Board staff draft a proposed cease-and-desist order and, with Reserve Bank staff, present it to the bank or individual for their consent before submitting the case to the Board. Banks or individuals are advised that they may have legal counsel present at all meetings with Board or Reserve Bank staff concerning formal corrective actions. If the parties voluntarily agree to settle the case by the issuance of a consent cease-and-desist order, the proposed consent order will be presented to Board officials for ratification and formal issuance of the order, at which time the order will be final and binding.

When a bank or person fails to consent to a cease-and-desist order, the Board may issue a "notice of charges and of hearing" to the bank or party. The notice of charges contains a detailed statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing starts a formal process that includes the convening of a public administra-

tive hearing⁴ conducted before an administrative law judge, appointed by the Board. After the hearing, the judge makes a recommended decision to the Board. A hearing must be held within 30 to 60 days of service of the notice of charges, unless a later date is set by the administrative law judge. After the Board considers the record of the proceeding, including the administrative law judge's recommended decision, it determines whether to issue a final cease-and-desist order. Banks and individuals who are subject to cease-and-desist orders that were issued as a result of contested proceedings may appeal the order to the appropriate federal court of appeals.

Temporary Cease-and-Desist Orders

In the event that a violation or threatened violation of law, rule, or regulation, or the engagement in an unsafe or unsound practice specified in the notice of charges, is likely to cause the bank's insolvency, cause significant dissipation of the bank's assets or earnings, weaken the bank's condition, or otherwise prejudice the interests of depositors before the completion of the proceedings (initiated by the issuance of the notice of charges), the Board may, in conjunction with issuing a notice of charges, issue a temporary cease-and-desist order against the bank or any institution-affiliated party to effect immediate correction (pursuant to 12 USC 1818(c)). The Board may also issue a temporary order if it determines that the bank's books and records are so incomplete or inaccurate that the Board is unable to determine, through the normal supervisory process, the bank's financial condition or the details or purpose of any transaction that may have a material effect on its condition. The temporary order may require the same corrections as a formal cease-and-desist order. The advantage of issuing a temporary cease-and-desist order is that it becomes effective immediately after it is served on the entity or individual. Within 10 days after being served with a temporary order, however, the entity or individual may appeal to a U.S. district court for relief from the order. Unless set aside by the district court, the temporary order stays in effect until the Board issues a final cease-and-desist order or dismisses the action.

4. A private hearing may be held if the Board determines that holding a public hearing would be contrary to the public interest.

Written Agreements

When circumstances warrant a less severe form of formal supervisory action, a written agreement may be used. A written agreement may be with either the Board or with the Reserve Bank under delegated authority (12 CFR 265.11(a)(15)). All written agreements must be approved by the Board's director of the Division of Banking Supervision and Regulation and the general counsel. The provisions of a written agreement may relate to any of the problems found at the bank or to any problems involving institution-affiliated parties.

Prohibition and Removal Authority

The Board is authorized by 12 USC 1818(e) to remove any current institution-affiliated party of a bank for certain violations and misconduct and to prohibit permanently from the banking industry any current or former institution-affiliated party from future involvement with any insured depository institution, bank or thrift holding company, and nonbank subsidiary.⁵

The Board is authorized to initiate removal or prohibition actions in the following situations:

- The institution-affiliated party has directly or indirectly—
 - violated any law, regulation, cease-and-desist order, condition imposed in writing, or written agreement;
 - engaged in any unsafe or unsound practice; or
 - breached a fiduciary duty.
- The Board determines that, because of the violation, unsafe or unsound practice, or breach—
 - the institution has suffered or will probably suffer financial loss or other damage;
 - the interests of depositors have been or could be prejudiced by the violation, practice, or breach; or
 - the institution-affiliated party has received financial gain or other benefit from the violation, practice, or breach.
- A violation, practice, or breach—
 - involves personal dishonesty or

- demonstrates a willful or continuing disregard for the safety or soundness of the institution.

In 1992, 12 USC 1818(e) was amended to authorize the Board to initiate removal or prohibition actions against (1) any institution-affiliated party who has committed a violation of any provision of the Bank Secrecy Act that was not inadvertent or unintentional, (2) any officer or director of a bank who has knowledge that an institution-affiliated party has violated the money-laundering statutes and did not take appropriate action to stop or prevent the reoccurrence of such a violation, or (3) any officer or director of a bank who violates the prohibitions on management interlocks. These removal or prohibition actions do not require a finding of gain to the individual, loss to the institution, personal dishonesty, or willful or continuing disregard for the safety or soundness of the institution.

Like a cease-and-desist order, a removal or prohibition order may be issued either by consent or after an administrative process initiated by the issuance of a notice of intent to remove and prohibit.

In the event that an institution-affiliated party's actions warrant immediate removal from a state member bank, the Board is authorized to suspend the person temporarily from that bank pending the outcome of the complete administrative process. An institution-affiliated party presently associated with a bank may also be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, bank holding company, or "business institution." Business institution is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

Under 12 USC 1818(g), the Board is authorized to suspend from office or prohibit from further participation any institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law if the continued participation might threaten either the interests of depositors or public confidence in the bank. The Board may also suspend or prohibit any individual charged with a violation of the money-laundering statutes. The suspension can remain in effect until the criminal action is disposed of or until the suspension

5. This is distinct from the Board's authority under prompt corrective action to dismiss senior officers from a particular bank.

is terminated by the Board. The Board may also initiate a removal or prohibition action against an institution-affiliated party who has been convicted of, or pleaded to, a crime involving personal dishonesty or breach of trust if his or her continued service would threaten the interests of the depositor or impair public confidence in the institution. However, the Board is required to issue an order removing or prohibiting any institution-affiliated party who has been convicted of, or pleaded to, a violation of the money-laundering statutes.

Furthermore, 12 USC 1829 prohibits any individual who has been convicted of a crime involving dishonesty, breach of trust, or money laundering from serving as an institution-affiliated party of, directly or indirectly participating in the affairs of, and owning or controlling, directly or indirectly, an insured depository institution without the FDIC's prior approval. Under certain circumstances, the statute also prohibits a convicted person from holding a position at a bank holding company or nonbank affiliate of a bank without the FDIC's prior approval. The penalty for violation of this law is a potential fine for a knowing violation of up to \$1 million per day, imprisonment for up to five years, or both. The criminal penalty applies to both the individual and the employing institution.

Violations of Final Orders and Written Agreements

When any final order has been violated, the Board may apply to a U.S. district court for enforcement of the action, and the court may order and require compliance.

Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending bank or institution-affiliated party, as circumstances warrant. The civil money penalty is assessed in the same manner as described in the civil money penalty subsection below.

Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to \$1 million, imprisonment for up to five years, or both.

Civil Money Penalties

The Board may assess civil money penalties of up to \$5,000 per day against any institution or institution-affiliated party for any violation of

(1) law or regulation; (2) a final cease-and-desist, temporary cease-and-desist, suspension, removal, or prohibition order; (3) a condition imposed in writing by the Board in connection with the granting of an application or other request; and (4) a written agreement.

A fine of up to \$25,000 per day can be assessed for a violation, an unsafe or unsound practice recklessly engaged in, or a breach of fiduciary duty when the violation, practice, or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss to the bank, or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to \$1 million per day can be assessed for any knowing violation, unsafe or unsound practice, or breach of any fiduciary duty when the offender knowingly or recklessly caused a substantial loss to the financial institution or received a substantial pecuniary gain or other benefit. Civil money penalties may also be assessed for any violation of the Change in Bank Control Act under the three-tier penalty framework described above.

The Board may also assess civil money penalties for the submission of any late, false, or misleading call reports. If a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors, but unintentionally fails to publish any report, submits any false or misleading report or information, or is minimally late with the report, it can be assessed a fine of up to \$2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. In the event that the error was not inadvertent or the bank lacked the appropriate procedures, a penalty of up to \$20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to \$1 million or 1 percent of the institution's assets, whichever is less, can be assessed for each day of the violation. The Board may also assess civil money penalties against any institution-affiliated party who participates in a bank's filing of late, false, or misleading call reports.

Administration of Formal Actions

Publication of Final Orders

Under 12 USC 1818(u), the Board is required to

publish and make publicly available any final order issued for any administrative enforcement proceeding it initiates. These orders include cease-and-desist, removal, prohibition, and civil money penalties. The Board is also required to publish and make publicly available any written agreement or other written statement that it may enforce.

Public Hearings

Under 12 USC 1818(u), all formal hearings, including contested cease-and-desist, removal, and civil money penalty proceedings, are open to the public unless the Board determines that a public hearing would be contrary to the public interest. Transcripts of all testimony, copies of all documents submitted as evidence in the hearing, which could include examination or inspection reports and supporting documents (except those filed under seal), and all other documents, such as the notice and the administrative law judge's recommended decision, are available to the public.

Section 914 Requests

New directors and senior executive officers at state member banks that meet certain criteria are subject to a 30-day review period before they can be retained or appointed, as required by section 914 of FIRREA (12 USC 1831i). The statute applies to appointments (or promotions to the senior-executive-officer level) in state member banks that (1) were chartered within the last two years, (2) underwent a change in control within the last two years, (3) have inadequate capital levels, or (4) are otherwise in troubled condition.⁶ Before assuming their positions, prospective directors and senior executive officers must file a notice with the Board and await the results of its 30-day review.

6. As defined in the Board's Regulation H, a bank is in troubled condition if it (1) has a composite rating, determined at its most recent examination, of 4 or 5; (2) is subject to a cease-and-desist order or formal written agreement that requires actions to improve the bank's financial condition; or (3) is expressly informed by the Board or Reserve Bank that it is in troubled condition.

Interagency Notification

Under interagency agreements, any federal banking regulatory agency that initiates a formal or informal enforcement action and that completes any formal or informal action against a commercial bank must notify the other federal financial institution regulatory agencies (including the OTS) of the action. This policy applies to formal administrative actions taken by the federal banking agencies, including cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalty assessments, and to informal corrective actions such as memoranda of understanding. All notifications must be written and transmitted to or received by both the regional and head offices of the agencies.

To foster federal-state agency coordination, the Federal Reserve provides the appropriate state supervisory authority with notice of its intent to institute a formal corrective action against a bank or its institution-affiliated parties, pursuant to 12 USC 1818(m).⁷

INFORMAL SUPERVISORY ACTIONS

Informal supervisory tools are used when circumstances warrant a less severe form of action than the formal supervisory actions described in this section. Informal actions are not enforceable and their violation cannot serve as a basis for assessing a civil money penalty or initiating a removal and prohibition action. Informal actions are not published or publicly available. These informal actions include the following:

- *Commitments.* These are generally used to correct minor problems or to request periodic reports addressing certain aspects of a bank's operations. Commitments may be used when there are no significant violations of law or unsafe or unsound practices and when the bank and its officers and directors are expected to cooperate and comply.⁸ Commitments are generally obtained by the Reserve Bank's

7. The procedures for notification to state agencies and other federal banking regulatory agencies are outlined in SR-84-34, "Joint Policy Statement on Interagency Exchange of Supervisory Information," December 19, 1984.

8. Informal commitments are distinct from conditions imposed in writing in connection with the grant of an application or other request by an institution, which may be enforced through the imposition of a civil money penalty.

sending a letter to the bank outlining the request and asking for a response and an indication that the commitments are accepted.

- *Board resolutions.* These generally represent a number of commitments made by the bank's directors and incorporated into the bank's corporate minutes. The Reserve Bank may request board resolutions in the examination transmittal letter, which asks the bank to provide it with a signed copy of the corporate resolution.
- *Memorandums of understanding (MOU).* These are highly structured written, but informal, agreements that are signed by both the Reserve Bank and the bank's board of directors. An MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by present management. Although an informal action, imposition of an MOU may require disclosure to the Securities and Exchange Commission and to the bank's liability bond issuer.